No. 00-511-CFX Title: Verizon Communications Inc., et al., Petitioners
v.
Federal Communications Commission, et al.

Docketed: October 4, 2000 Court: United States Court of Appeals for the Eighth Circuit

Vide:
00-555
00-587
00-590
00-602

Entry	Date	Proceedings and Orders
	Oct 4 2000	Petition for writ of certiorari filed. (Response due November 17, 2000)
	Oct 4 2000	LODGING consisting of 10 copies relating to reports of the FCC submitted by the petitioners (Volumes I & II).
	Oct 19 2000	Waiver of right of respondent Mississippi Public Service Commission to respond filed.
	Oct 20 2000	Waiver of right of respondent Kansas Corporation Commission to respond filed.
	Oct 20 2000	Waiver of right of respondent Sprint Corporation to respond filed.
	Nov 2 2000	Waiver of right of respondent North Carolina Utilities Commission to respond filed. VIDED.
	Nov 6 2000	Waiver of right of respondent Public Service Commission of WI to respond filed.
	Nov 6 2000	Waiver of right of respondent Qwest Corporation to respond filed.
	Nov 7 2000	Order extending time to file response to petition until November 17, 2000.
	Nov 17 2000	Brief of respondents WORLDCOM, Inc., et al. in opposition filed.
	Nov 17 2000	Brief of respondents Federal Communications Commission and the United States filed. VIDED.
	Nov 17 2000	Waiver of right of respondent AT&T Corporation to respond filed.
	Nov 28 2000	Reply brief of petitioners Verizon Communications Inc., et al. filed.
	Nov 29 2000	DISTRIBUTED for Conference of January 5, 2001
	Jan 8 2001	REDISTRIBUTED for Conference of January 12, 2001
	Jan 16 2001	REDISTRIBUTED for Conference of January 19, 2001
	Jan 22 2001	Petition GRANTED. limited to the following questions: 1) Whether the court of appeals erred in holding that 47 U.S.C. Sec. 252(d)(1) (Telecommunications Act of 1996) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies. 2) Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local

3 pp

Entry	Date	Proceedings and Orders
		exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements. 3) Whether 47 U.S.C. Sec. 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task. Justice O'Connor OUT. SET FOR ARGUMENT October 10, 2001. **********
	Feb 7 2001	Letter received from counsel for General Communications,Inc., waiving the right to file a brief on the merits. VIDED.
	Feb 15 2001	Order adopting the Solicitor General's proposal for simultaneous briefing. Opening briefs for petitioners and opening briefs for respondents supporting those petitioners are due on or before April 9, 2001. Briefs for respondents opposing petitioners are due on or before June 8, 2001. Reply briefs, if any, are due on or before July 23, 2001.
	Apr 9 2001	Brief of respondent Sprint Corporation in support of petitioners filed. VIDED.
	Apr 9 2001	Brief of petitioners Federal Communications Commission and the United States filed. VIDED.
	Apr 9 2001	Brief of petitioners WorldCom, Inc., et al.(TBP) filed. VIDED.
	Apr 9 2001	Brief of petitioners Verizon Communications Inc., et al. filed. VIDED.
	Apr 24 2001	Motion of BellSouth Corporation, et al., for additional time for oral argument filed.
	Jun 7 2001	Brief of respondent National Association of State Utility Consumer Advocates filed. VIDED.
	Jun 8 2001	Brief of respondent Sprint Corporation filed. VIDED.
	Jun 8 2001	Brief amici curiae of Allegiance Telecom, Inc., et al. filed.
	Jun 8 2001	Brief of respondent Qwest Communications International, Inc. filed. VIDED.
	Jun 8 2001	Brief of respondent AT&T Corporation filed. VIDED.
	Jun 8 2001	Brief of respondents Federal Communications Commission and the United States filed. VIDED.
	Jun 8 2001	Brief of respondents Public Service Commission of State of New York and NARUC filed. VIDED.
	Jun 8 2001	Brief of respondents WORLDCOM, Inc., et al. filed. VIDED.
	Jun 19 2001	Motion of the Solicitor General for divided argument filed.
	Jun 29 2001	Motion of the Solicitor General for divided argument GRANTED. Justice O'Connor OUT.
	Jun 29 2001	Motion of BellSouth Corporation, et al., for additional time for oral argument GRANTED. Thirty additional minutes are allotted for this purpose. to be divided as follows: 45 minutes for petitioners in No. 00-511, 15

Entry	Date	Proceedings and Orders
		minutes for petitioners in Nos. 00-555 and 00-590, and 30 minutes for the Solicitor General. Justice O'Connor OUT.
	Jul 6 2001	LODGING consisting of 20 copies of publication entitiled "Telecommunications Act at three years", submitted by counsel for amicus Qwest.
	Jul 23 2001	Reply brief of respondent Sprint Corporation in support of petitioners filed. VIDED.
	Jul 23 2001	Reply brief of petitioners United States and the Federal Communications Commission filed. VIDED.
	Jul 23 2001	LODGING consisting of 20 copies of supplemental opinion of the Postal Commission, submitted by Verizon Entities.
	Jul 23 2001	Reply brief of petitioners Verizon Communications Inc., et al. filed. VIDED.
	Jul 23 2001	Reply brief of respondent AT&T Corporation filed. VIDED.
	Jul 26 2001	CIRCULATED.
	Aug 6 2001	Joint appendix filed.
	Aug 6 2001	Joint appendix in two volumes. VIDED.
	Aug 6 2001	LODGING consisting of 20 copies of two bound volumes of related material submitted by counsel for respondents Worldcom, et al.
	Aug 6 2001	LODGING consisting of twenty copies of supplemental material submitted by counsel for Worldcom, et al. and distributed.
	Sep 26 2001	Record filed.
	Oct 2 2001	LODGING consisting of 20 copies of transcript of testimony submitted by counsel for petitioners and distributed.
	Oct 5 2001	LODGING consisting of twenty sets of three bound volumes of related material submitted by counsel for the respondents and distributed
	Oct 9 2001	Letter from counsel for the petitioners received and distributed.
	Oct 10 2001	ARGUED.

(1)

FILED

No. 00-___ 00 511 OCT 4 - 2000

IN THE

Supreme Court of the United States

OFFICE OF THE CLERK

OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,*

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1301 K Street, N.W.
Washington, D.C. 20005
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., and United States Telecom Association

CHARLES R. MORGAN
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-4839

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON SERVICES GROUP
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

October 4, 2000

Additional Counsel Listed on Inside Cover

---

* The full list of Petitioners is set forth in the List of Parties, *infra* p. ii.

216pp

JAMES D. ELLIS
ALFRED G. RICHTER, JR.
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
HOPE E. THURROTT
CHARLES J. SCHARNBERG
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States
Telecom Association

QUESTION PRESENTED

The Telecommunications Act of 1996 requires incumbent local telephone companies to turn over "elements" of their local exchange networks for competitors to use and specifies that prices for these "network elements" must be "just" and "reasonable," "shall be based on the cost . . . of providing . . . the network element," and "may include a reasonable profit." 47 U.S.C. § 252(d)(1).

Did the FCC act unlawfully in implementing this pricing standard by prescribing a pricing methodology that requires prices based solely on "forward-looking" costs and by denying incumbent carriers an opportunity to recover the historical costs they have incurred in constructing their networks?

LIST OF PARTIES AND RULE 29.6 STATEMENT

The Petitioners in this Court are:

Verizon Entities, consisting of:

Verizon Communications Inc.
GTE Service Corporation
GTE Alaska Incorporated
GTE Arkansas Incorporated
Verizon California Inc. (f/k/a GTE California Incorporated)
Verizon Florida Inc. (f/k/a GTE Florida Incorporated)
GTE Midwest Incorporated
Verizon South Inc. (f/k/a GTE North Incorporated)
GTE Southwest Incorporated
Verizon North Inc. (f/k/a GTE North Incorporated)
Verizon Northwest Inc. (f/k/a GTE Northwest Incorporated)
Verizon Hawaii International Inc. (f/k/a GTE Hawaiian Telephone Company Incorporated)
Verizon West Coast Inc. (f/k/a GTE West Coast Incorporated)
Contel of Minnesota, Inc.
Contel of the South, Inc.

BellSouth Corporation
SBC Communications Inc.
United States Telecom Association

The parties to the proceedings in the Eighth Circuit are listed in the caption of the decision below, *see* Appendix A, 1a, and in Appendix F, *infra*.

Pursuant to Supreme Court Rule 29.6, Petitioners state as follows:

On June 30, 2000, GTE Corporation and Bell Atlantic Corporation closed their merger, and Bell Atlantic Corporation subsequently changed its name to Verizon Communications Inc. Verizon Communications Inc. is the ultimate parent of each of the other Verizon Entities listed above. No publicly

owned company owns 10% or more of the stock of Verizon Communications Inc.

SBC Communications Inc. has no parent company, and no publicly owned company owns more than 10% of its stock.

BellSouth Corporation has no parent company, and no publicly owned company owns more than 10% of its stock.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

LIST OF PARTIES AND RULE 29.6 STATEMENT ii

TABLE OF CONTENTS iv

TABLE OF AUTHORITIES vi

INTRODUCTION 1

OPINIONS BELOW 4

JURISDICTION 4

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED 4

STATEMENT 5

A. The Regulatory Background Prior to 1996 5

B. The Telecommunications Act of 1996 5

C. The FCC's Local Competition Order 7

D. Review of the Local Competition Order 10

E. GTE's Parallel Challenge to TELRIC in the Universal Service Case 13

REASONS FOR GRANTING THE WRIT 14

A. The Challenges to TELRIC Here Are Very Similar to Questions the Court Has Found Worthy of Review in the Universal Service Case, Yet Are Sufficiently Distinct and Important To Warrant Review in Their Own Right 14

1. This Case Presents Virtually the Same Core Challenges as the Universal Service Case 15

2. This Case Presents Distinct Questions of Construction Concerning the Pricing Standard of Section 252(d)(1) That Are Worthy of Review 19

B. This Case Presents an Even Better Vehicle for Addressing the Challenges to TELRIC. 22

CONCLUSION 24

TABLE OF AUTHORITIES

Cases — **Page(s)**

AT&T Corp. v. Iowa Utils. Bd.,
525 U.S. 366 (1999) 2, 3, 5, 7, 10, 11, 20, 21

Bell Atlantic Tel. Cos. v. FCC,
24 F.3d 1441 (D.C. Cir. 1994) 18

Brooks-Scanlon Co. v. Railroad Comm'n,
251 U.S. 396 (1920) 17

Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.,
467 U.S. 837 (1984) 11

Duquesne Light Co. v. Barasch,
488 U.S. 299 (1989) 5, 15, 17

Eastern Enters. v. Apfel,
524 U.S. 498 (1998) 20

GTE Service Corp. v. FCC,
120 S. Ct. 2214 (2000) 1, 14

Iowa Utils. Bd. v. FCC,
120 F.3d 753 (8th Cir. 1997) 3, 10

Monongahela Navigation Co. v. United States,
148 U.S. 312 (1893) 19

National Broiler Mktg. Ass'n v. United States,
436 U.S. 816 (1978) 20

Smith v. Illinois Bell Tel. Co.,
282 U.S. 133 (1930) 18

Texas Office of Pub. Util. Counsel v. FCC,
183 F.3d 393 (5th Cir. 1999),
Cert granted sub nom.
GTE Serv. Corp. v. FCC,
120 S. Ct. 2214 (2000) (No. 99-1244) 13, 17

US WEST, Inc. v. FCC,
182 F.3d 1224 (10th Cir. 1999),
cert. denied, 120 S. Ct. 2215 (2000) 18

Williams v. Babbitt,
115 F.3d 657 (9th Cir. 1997),
cert. denied, 118 S. Ct. 1795 (1998) 18

Constitutional Provision

U.S. Const. amend. V 4

Statutes

5 U.S.C. § 706 4
28 U.S.C. § 1254(1) 4
28 U.S.C. § 2342(i) 4
47 U.S.C. § 251 4
47 U.S.C. § 251(c)(2) 6
47 U.S.C. § 251(c)(3) 6
47 U.S.C. § 251(c)(4) 6
47 U.S.C. § 251(d)(2) 6
47 U.S.C. § 252 4
47 U.S.C. § 252(d)(1) 2, 7, 11, 14, 19, 20
47 U.S.C. § 252(d)(1)(A) 6

47 U.S.C. § 252(d)(1)(B) 6
47 U.S.C. § 252(d)(3) 7
47 U.S.C. § 254(d) 7
47 U.S.C. § 254(e) 7
47 U.S.C. § 402(a) 4

Regulations

47 C.F.R. §§ 51.501-51.511 4

Agency Orders

In re Federal-State Joint Board on Universal Service, Report & Order,
12 F.C.C.R. 8776 (1997) 5, 13

In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,
First Report & Order,
11 F.C.C.R. 15,499 ..... 3, 4, 8, 9, 12, 17, 22

Miscellaneous

Comments of MCI Telecommunications Corp.
in *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*,
CC Docket No. 96-98 (filed May 16, 1996) 13

H.R. Rep. 104-458 (1996) 6

No. 00-___

IN THE

Supreme Court of the United States

OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *et al.*,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

INTRODUCTION

The Verizon Entities, BellSouth Corporation, SBC Communications Inc., and the United States Telecom Association petition this Court for a writ of certiorari to review the judgment of the Eighth Circuit.

In *GTE Service Corp. v. FCC*, No. 99-1244 (the "Universal Service Case"), the Court granted certiorari to address challenges to the FCC's use of its novel "TELRIC" methodology for determining funding for "universal service" – that is, compensation to which incumbent local telephone companies are entitled under the Telecommunications Act of 1996 for providing service to some customers at regulated,

below-cost rates.[1] This case involves similar challenges to TELRIC, but it arises from the order in which the FCC actually invented TELRIC and involves the FCC's determination that TELRIC sets the exclusive standard for determining the compensation incumbents receive under the Act for the forced use by competitors of pieces or "elements" of their local networks.

The Court should grant certiorari in this case because (1) this case and the Universal Service Case require application of common principles to distinct statutory provisions, each of which raises its own questions of construction and each of which is sufficiently important to the success of the 1996 Act to warrant review independently, and (2) a decision in the Universal Service Case cannot resolve the questions presented by this case. Indeed, the Government has announced that it will seek review of the Eighth Circuit's decision, *see* Brief for the FCC and the United States in No. 99-1244, at 11 n.7, 35 n.29 (filed Sept. 28, 2000), and we understand that it favors scheduling the two cases to be heard concurrently.

Review is especially warranted here because interpretation of the pricing standard for network elements in 47 U.S.C. § 252(d)(1) presents distinct questions that are vitally important for the success of the 1996 Act. This case involves the same Local Competition Order that merited the Court's attention in *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999). Reviewing the Eighth Circuit's decision here will thus complete the substantive review of the Order that the Court

---

[1] On June 30, 2000, GTE Corporation and Bell Atlantic Corporation closed their merger, and the combined company is now Verizon Communications Inc. The petitioning Verizon entities are referred to here collectively as "Verizon." Because the petition in No. 99-1244 was filed before the closing of the merger, it was filed in the name of various GTE entities (referred to here as "GTE").

began in *AT&T Corp.* and, most important, conclude the litigation over the critical pricing standard in section 252(d)(1) that has created uncertainty in implementing the Act for the past four years.

Indeed, this case presents a substantially better vehicle for addressing the core challenges to TELRIC that the Court has decided to hear. *First*, this case arises on review of the Local Competition Order[2] in which the FCC first developed TELRIC. This case thus involves the foundational proceeding in which the battle over TELRIC was fully joined before the agency. It was in this case that interested parties filed the most extensive comments and in which the FCC provided the most complete statement of its rationale for TELRIC. The universal service proceeding, in contrast, involved only a derivative application of the novel methodology and thus provides only an abbreviated record for review. That case reached this Court first, moreover, solely because the Eighth Circuit originally struck down all of the FCC's pricing rules on jurisdictional grounds and turned to the merits of TELRIC only upon remand from *AT&T Corp.*

Second, there are no threshold obstacles to review of TELRIC in this case. In the Universal Service Case, by contrast, the FCC has claimed that the Court cannot even reach constitutionally based challenges to TELRIC because TELRIC has not been used to set the full support incumbents receive for universal service. The FCC's assertions are inaccurate, but the

---

[2] *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15,499 (1996) ("Local Competition Order"), *pet. for review granted in part, denied in part, Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part, rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999), and *pet. for review granted in part, denied in part, Iowa Utils. Bd. v. FCC*, 219 F.3d 744 (8th Cir. 2000).

Court would not even need to sort through such preliminary issues to address the merits of TELRIC in this case.

To ensure that the challenges to TELRIC are finally resolved, and particularly that there is a definitive construction this Term of the critical pricing standard in section 252(d)(1), the Court should grant this petition.

OPINIONS BELOW

The Eighth Circuit's decision is reported at 219 F.3d 744, and is reprinted in the Appendix at pages 1a-43a. The Local Competition Order, *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, First Report & Order, is reported at 11 F.C.C.R. 15,499, and relevant portions are reprinted at pages 44a-151a.

JURISDICTION

The Court of Appeals had jurisdiction pursuant to 28 U.S.C. § 2342(i) and 47 U.S.C. § 402(a). The Eighth Circuit issued its opinion and judgment on July 18, 2000. This Court has jurisdiction under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED

This case involves the Takings Clause, U.S. Const. amend. V ("nor shall private property be taken for public use without just compensation"); sections 251 and 252 of the Telecommunications Act of 1996, 47 U.S.C. §§ 251, 252; 5 U.S.C. § 706; and 47 C.F.R. §§ 51.501-51.511. The statutory provisions and regulations are reproduced in the Appendix.

STATEMENT

A. The Regulatory Background Prior to 1996

For most of the twentieth century, local telephone service was regulated under the assumption that it was a natural monopoly. State public utility commissions typically granted a single company (now known as the incumbent local exchange carrier or "ILEC") an exclusive franchise to provide local telephone service within a designated service area. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). The incumbent invested the huge sums necessary to construct a ubiquitous telephone network and undertook the obligation of providing service to *all* customers in its service area. The State, for its part, set rates to allow incumbents to recover their investments and a constitutionally sufficient return. *Cf. Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). For decades, regulators based rate determinations on the historical costs reflected on incumbents' books.

In addition, regulators used their power to regulate rates to advance the public policy goal of "universal service" – that is, ensuring that basic telephone service was available for all consumers, even those in rural and other high-cost areas, at low affordable rates. Regulators typically accomplished that goal through implicit subsidies embedded in retail rates. To give just one example, rates for urban and business customers were typically set above cost so that rates for other customers (usually rural and residential customers) could be set below cost. *See generally In re Federal-State Joint Board on Universal Service*, Report & Order, 12 F.C.C.R. 8776, ¶ 11 (1997).

B. The Telecommunications Act of 1996

In the Telecommunications Act of 1996, Congress rejected the assumption that the local exchange was a natural monopoly. Congress intended the Act to establish a "pro-competitive, de-

regulatory" framework for introducing full competition into all segments of the telecommunications industry. *See* H.R. Rep. 104-458, at 113 (1996).

To hasten the transition to competition in the local exchange, Congress imposed a number of duties on incumbents. *First*, Congress required each incumbent to allow other carriers to "interconnect" with its network. *See* 47 U.S.C. § 251(c)(2). *Second*, Congress required incumbents to provide new entrants access on an unbundled basis to pieces, or "elements," of their networks. *See id.* § 251(c)(3). *Third*, Congress required incumbents to sell their finished services to new entrants at wholesale rates so that entrants could resell the service under their own brand names. *See id.* § 251(c)(4).

At the same time that it decreed this forced access to incumbents' property, Congress imposed important limitations on incumbents' new obligations. With respect to network elements, the Act specified that, "[i]n determining what network elements should be made available," the FCC "shall consider" whether access to proprietary elements was "necessary" and whether failure to provide access to non-proprietary elements would "impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer." § 251(d)(2).

In addition, Congress established pricing standards designed to ensure that incumbents would be paid constitutionally sufficient compensation for the forced uses of their property mandated by the Act. Thus, the Act directed that, for interconnection and unbundled network elements, new entrants are to pay "just" and "reasonable" rates, § 251(c)(3), that "shall be based on the cost . . . of providing the interconnection or network element" and "may include a reasonable profit." § 252(d)(1)(A), (B). Similarly, the Act specified that wholesale rates for finished services must be based on the retail rates for

the services, excluding costs "that will be avoided by the [incumbent] local exchange carrier." § 252(d)(3).

Congress also recognized that the system of implicit subsidies that regulators had maintained in retail rates would no longer be sustainable in a competitive environment. Once markets were opened to competition, above-cost rates for some customers would simply attract new entrants who would cream-skim the customers that formerly subsidized below-cost rates for others. Entrants could undercut incumbents' rates, strip away those customers, and pocket for themselves most of the margin that had supported universal service. As this Court explained, new entrants could "lure business customers away from incumbents by offering rates closer to cost" and thereby "leave the incumbents holding the bag for universal service." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 393 (1999). Congress therefore directed the FCC to establish a new funding mechanism for universal service that would be "explicit and sufficient," § 254(e), and that would require contributions from carriers on an "equitable and nondiscriminatory basis," § 254(d).

C. The FCC's Local Competition Order

In August 1996, the FCC released its Local Competition Order – its first and most comprehensive order addressing implementation of the 1996 Act. In this 700-plus page Order, the FCC addressed a host of issues critical for accomplishing the Act's primary objective of opening the local exchange to competition including, most importantly, rules governing both pricing for unbundled network elements and access to those elements.

Incumbents had explained that the terms of the statute directing that prices for network elements "shall be based on the cost . . . of providing" the elements, § 252(d)(1), required the FCC to base prices on the actual, historical costs reflected

on incumbents' books (or to establish some other mechanism for covering those costs). Incumbents pointed out that abruptly abandoning the historical-cost measures that had traditionally been used for establishing incumbents' rates and resorting instead to a forward-looking cost methodology would raise serious constitutional questions by stranding investments that had been made under the historical-cost regime and were not yet recovered. In addition, incumbents argued that, even if a forward-looking cost measure were used, it must be based on the actual forward-looking costs of incumbents' real-world networks.

The FCC, however, categorically rejected the use of historical costs. *See* Local Competition Order ¶¶ 672-673, 704-707 (Pet. App. 98a-99a, 121a-126a). Instead, the FCC concluded that it should set prices by attempting to project the forward-looking costs of a hypothetical, ideally efficient carrier that deployed at all times only the most up-to-date technology. *Id.* ¶¶ 679, 683-685 (Pet. App. 103a, 106a-108a). The FCC invented a new methodology for projecting these costs, which it dubbed "Total Element Long Run Incremental Cost" or "TELRIC." *Id.* ¶ 678 (Pet. App. 101a-102a). The FCC rejected even a forward-looking cost approach that would take into account the actual forward-looking costs that an incumbent would incur in operating its real-world network. According to the FCC, because such a methodology was "not based on a hypothetical network," it would reflect inefficiencies in an incumbent's existing network design. *Id.* ¶ 684 (Pet. App. 106a-107a). Instead, in TELRIC the FCC sought to project the costs of a hypothetical, optimally configured network. TELRIC's one concession to the reality of the incumbent's existing network was to use an incumbent's existing wire center locations. *See id.* ¶ 685 (Pet. App. 107a-108a). The FCC not only set the parameters of its TELRIC methodology. It also went so far as to set specific rates for network elements

– so-called "proxy prices" – based on existing forward-looking cost studies that, in the FCC's view, produced results approximating TELRIC.

The FCC also provided entrants extraordinarily expansive access to incumbents' network elements. According to the FCC, the Act required incumbents to turn over as an unbundled element any part of their network that it was technically feasible to turn over, *see id.* ¶ 278, and any restriction on access imposed by the "necessary" and "impair" standards of section 251(d)(2) had to be construed so as not to conflict with this overarching imperative of unlimited access, *id.* ¶¶ 286-287.

The FCC's TELRIC pricing rule and its grant of blanket access to network elements formed complementary parts of the FCC's overall vision for implementing the transition to competition under the Act. Together they reflected the FCC's view that facilities-based competition was merely "unnecessary" "duplication," *id.* ¶ 287, and that it was preferable effectively to nationalize the incumbent's network and to sell it off to competitors at prices that the FCC – acting as an omnipotent central planner – had determined would reflect the best levels that might someday be achieved in a fully competitive market.

That approach ignored the fact that competition is a *process* in which various entrants introduce innovations and new efficiencies and thereby gradually drive prices down. The FCC, indeed, revealed a distinct antipathy to allowing that process to unfold. The FCC sought to leapfrog by regulatory *diktat* to the end result that the FCC thought competition might produce. The combined effect of joining that pricing approach with virtually unrestricted access to any and all parts of the incumbent's network would have been to choke off the very development of competition that Congress had intended to foster. New entrants would have little incentive to risk deploying facilities of their own if they could buy the use of the

existing network at prices set to reflect the costs of an *ideally* efficient carrier. Instead, the FCC's approach was designed to promote solely a sort of "Potemkin village" competition – the rapid proliferation of a number of so-called "competitors" that would be in reality nothing more than resellers, all using the same underlying facilities (the incumbent's) to provide service under different brand names.

D. Review of the Local Competition Order

In the first round of judicial review of the Local Competition Order, incumbent LECs brought essentially three major challenges. Incumbents argued (i) that the FCC lacked statutory authority to issue rules governing the Act's pricing provisions at all; (ii) that the FCC's pricing rules – and particularly TELRIC – violated the Act and raised serious constitutional questions because they failed to provide constitutionally adequate compensation for forced use of incumbents' property and that they were arbitrary and capricious; and (iii) that the FCC's unbundling rules providing virtually unlimited access to incumbents' networks also violated the terms and purposes of the Act. The Eighth Circuit ruled that the FCC lacked jurisdiction over pricing and agreed with some (but not all) of incumbents' arguments concerning unbundling. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997).

This Court granted certiorari on numerous petitions and cross-petitions seeking review of the Eighth Circuit decision. In *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999), the Court ruled that the FCC has jurisdiction to establish a pricing methodology under sections 251 and 252, *see id.* at 377-85. The Court agreed with incumbents that the FCC had violated the terms of the Act by failing to impose any meaningful restriction on access to network elements. The Act required the FCC "to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to

do." *Id.* at 388. The Court therefore vacated the FCC's "primary unbundling rule." *Id.* at 375. In doing so, the Court struck down one of the two complementary halves of the FCC's vision for implementing the transition to competition demanded by the Act. Because the Eighth Circuit had struck down the FCC's pricing rules based solely on the FCC's lack of statutory authority, however, this Court did not address the other half of the FCC's approach – that is, the merits of TELRIC pricing for network elements.

On remand from *AT&T Corp.*, the Eighth Circuit reached the merits of incumbents' challenges to TELRIC. *First*, the Eighth Circuit agreed with incumbents that the FCC violated the Act's pricing standard by prescribing a rate methodology based on the costs of a hypothetical carrier using optimally efficient technology and configuration at any given time. The court explained that the statute's plain terms call for prices based on the cost to the incumbent of providing the actual element made available to competitors, "not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute." Pet. App. 8a. As the Eighth Circuit put it, in setting the pricing standards of section 252(d)(1), "Congress was dealing with reality, not fantasizing about what might be." *Id.* at 9a.[3]

Second, the court rejected incumbents' claim that compensation for network elements must recover the historical costs reflected on incumbents' books. In the court's view, the term "cost" was ambiguous, and the FCC's decision to base prices on forward-looking costs was a reasonable construction entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984).

---

[3] Because it struck down the hypothetical aspects of TELRIC as contrary to the terms of the Act, the court did not address incumbents' further arguments that this aspect of TELRIC was also arbitrary and capricious.

Third, the court rejected incumbents' claim that, as long as retail rates continued to include implicit cross-subsidies, prices for network elements should reflect the costs imposed by the subsidy system. Pet. App. 15a.

Fourth, the court addressed incumbents' claim that the statute should be construed to avoid the grave constitutional issues that would be raised by using hypothetical TELRIC projections to compensate incumbents for turning over their property to competitors.[4] Although the court acknowledged that incumbents had argued for a narrowing construction of the Act to avoid a taking, it proceeded to apply the wrong standard to incumbents' claim as it concluded that petitioners' "takings claim is not ripe for review." Pet. App. 17a. The court went on to assert that "a takings claim cannot be based on the ratemaking methodology," but rather must be based on the impact of the rate itself. *Id.* The court thus ignored the fact that, in a declining cost industry such as this, TELRIC's projections of the forward-looking costs of an ideally efficient carrier would necessarily produce rates lower than the costs an incumbent actually has incurred. Indeed, the FCC adopted TELRIC with precisely that objective of lower prices in mind.[5]

---

[4] The court suggested that, because it had already struck down the FCC's decision to base prices on projections for a hypothetical carrier as contrary to the terms of the Act, it might not be necessary for it to address the further argument that the Act should be construed to preclude TELRIC to avoid grave constitutional issues. *See* Pet. App. 16a. Nevertheless, the court determined that "to avoid as best we can another remand," it would proceed to address the claims for constitutional narrowing on the merits. In any event, despite the court's suggestions, as explained in text, the constitutional infirmity in TELRIC warranting a narrowing construction arises not solely from TELRIC's focus on a hypothetical carrier (rather than an incumbent's actual costs), but also from the fact that TELRIC ignores historical costs. Thus, it was necessary for the Eighth Circuit to address the claims for a narrowing construction to resolve the case.

[5] *See, e.g.*, Local Competition Order ¶ 706 (rejecting use of historical costs because it would "increas[e]" rates for network elements) (Pet. App. 124a-125a); Comments of MCI Telecommunications Corp. at 63, 65 in *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 16, 1996) (arguing that prices based on historical costs would be "higher than" prices using forward-looking costs and that "rates based on historical costs are excessive").

The court also ignored the rates that the FCC had decided were accurate proxies for TELRIC. Lastly, the court concluded that it should afford ordinary deference under *Chevron* to the FCC's pricing determinations and that incumbents' constitutionally based arguments for interpreting the Act provided no basis for limiting the ordinary application of *Chevron*. *See id.* at 18a.

E. GTE's Parallel Challenge to TELRIC in the Universal Service Case

Nine months after issuing its Local Competition Order, the FCC issued an order addressing Congress' command in section 254 of the Act that there should be new mechanisms for supporting universal service that would be sustainable in a competitive marketplace. *See In re Federal-State Joint Board on Universal Service*, Report & Order, 12 F.C.C.R. 8776 (1997). In establishing a new explicit federal subsidy fund, the FCC decided that it would determine the cost of providing universal service by effectively transporting into the universal service context the TELRIC methodology it had originally developed for setting network-element prices. *See id.* ¶¶ 224-228, 250.

On July 30, 1999, the Fifth Circuit rejected GTE's challenges to this second use of TELRIC. *See Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom., GTE Serv. Corp. v. FCC*, 120 S. Ct. 2214 (2000). The court dismissed GTE's arguments for a narrowing construction of the Act in a perfunctory footnote, *see id.* at 413

n.14, and concluded that it should defer under *Chevron* to the FCC's use of TELRIC to set federal support for universal service.

GTE sought review in this Court, and on June 5, 2000, the Court granted GTE's petition for certiorari. *See* 120 S. Ct. 2214.

REASONS FOR GRANTING THE WRIT

A. The Challenges to TELRIC Here Are Very Similar to Questions the Court Has Found Worthy of Review in the Universal Service Case, Yet Are Sufficiently Distinct and Important To Warrant Review in Their Own Right.

The Court has, in effect, *already decided* that the fundamental challenges to TELRIC raised here merit this Court's review. The Court granted certiorari in *GTE Service Corp. v. FCC*, 120 S. Ct. 2214 (2000) (No. 99-1244), to address the application to TELRIC of the same constitutional and administrative law principles at issue here, but in the context of construing a distinct statutory provision concerning universal service. As outlined below, essentially the same core challenges to TELRIC will be presented in this case, but here the question will be how those principles inform interpretation of the statutory directives that prices for network elements must be "just" and "reasonable," "shall be based on . . . cost," and "may include a reasonable profit." 47 U.S.C. § 252(d)(1). Because different statutory sections are involved, application of the constitutional and administrative law principles in the two cases will raise distinct questions. Their proper application in this case is sufficiently important to warrant this Court's separate attention.

1. This Case Presents Virtually the Same Core Challenges as the Universal Service Case.

As outlined below, each of the major challenges the Court found worthy of review in the Universal Service Case has a close analog in this case.

a. The Eighth Circuit rejected incumbents' argument that compensation for network elements must take into account incumbents' historical costs. *See* Pet. App. 11a. This case, like the Fifth Circuit case, will thus present the question whether it was unlawful under this Court's decision in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), for the FCC to switch rate methodologies in midstream (from historical costs to a forward-looking methodology) without making provision for recovery of the investments that would be stranded by the shift in methodology itself. *Cf.* Pet'n for Cert. in No. 99-1244, at i (Question Presented part (a)).

In *Duquesne*, the Court made clear that when a regulator switches rate methodologies, the constitutional adequacy of the new methodology must be judged by determining whether (as to past investments) it continues to produce recovery that is "within the constitutional range of reasonableness" *as measured under the prior system*. *See* 488 U.S. at 312. The FCC's abrupt jettisoning of historical costs in favor of a forward-looking methodology for setting network-element rates plainly fails that test. The FCC categorically prohibited using historical costs to set network-element prices and refused to make any other provision for recovering those costs.

In *Duquesne*, moreover, the Court also explained that opportunistically switching rate methodologies – for example, setting rates based on historical costs when market values are increasing and then changing to use forward-looking costs when costs are falling – would raise "serious constitutional questions." *Id.* at 315. The FCC's action here is precisely such

a switch. For decades, incumbents' rates have been based on historical costs. Part of the FCC's purpose in abruptly changing to forward-looking costs for network-element prices was to take advantage of rapid technological progress that has produced lower costs. Use of forward-looking costs was thus deliberately designed to yield *lower* network-element prices. *See supra* n.5. In upholding the FCC's switch to a forward-looking rate method, the Eighth Circuit essentially ignored the Court's warnings in *Duquesne*.

The Eighth Circuit's analysis of incumbents' arguments for constitutional narrowing was also plainly flawed. To start, the court declared that incumbents' "takings claim is not ripe for review." Pet. App. 17a. But that misunderstands the nature of the claim. Incumbents were not bringing a "takings claim" for compensation. Rather, they argued that the statute should be construed to avoid the grave constitutional issues that would be raised by the FCC's approach to pricing. An assessment of whether a "takings claim" was "ripe" was thus entirely beside the point.

In addition, in elaborating its "ripeness" analysis, the court asserted that incumbents could not challenge any FCC rate methodology "until . . . rates have been determined *and applied*." Pet. App. 18a (emphasis added). That approach essentially means that the FCC's methodology could never be tested in advance to determine whether it will satisfy constitutional requirements. Instead, rather than ensuring *now* that the Act is construed properly to provide constitutionally adequate compensation, in the Eighth Circuit's view, incumbents must wait until the FCC's rates have been "applied" and have actually produced a taking before they can challenge the FCC's pricing determinations. That also flatly misunderstands *Duquesne*. The test the Court applied in *Duquesne* to evaluate the "impact" of a rate order, Pet. App. 17a, was a *prospective* test. The *Duquesne* Court itself

evaluated the effect that a new rate method "will" have. 488 U.S. at 312. It did not suggest that a constitutional challenge could not even be considered until after a regulated entity had already suffered a completed taking. *Duquesne* thus allows a challenge to a rate system like TELRIC that sets out, *by design*, to preclude recovery of costs that incumbents are constitutionally entitled to recover.

b. Incumbents' arguments concerning the constitutional adequacy of TELRIC also raise the question whether *other* sources of revenue can be considered in evaluating the compensation provided to incumbents. The FCC has asserted that incumbents' revenues from other services also must be taken into account in determining whether TELRIC rates failed to meet constitutional standards. *See* Local Competition Order ¶¶ 737, 738 (Pet. App. 148a-149a). In rejecting claims for a narrowing construction, the Eighth Circuit effectively left the FCC's rationale undisturbed.

But this Court's decision in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920), prohibits the FCC's approach. A regulated company cannot be forced to operate one line of business at a loss on the expectation that it will make up the shortfalls through revenues earned in competitive lines of business. *See id.* at 399. As Justice Holmes explained, the profits that an enterprise earns in competitive operations are private property, and the firm "no more can be compelled to spend that than it can be compelled to spend any other money to maintain [the enterprise] for the benefit of others who do not care to pay for it." *Id.*

This case thus also presents the issue of how *Brooks-Scanlon* applies to the FCC's rate-setting in the newly competitive environment created by the 1996 Act. *Cf.* Pet'n for Cert. in No. 99-1244, at ii (Question Presented part (b)); *cf. also Texas Office of Pub. Util. Counsel*, 183 F.3d at 413 n.14. Indeed, it presents the *Brooks-Scanlon* issue in virtually the clearest and

most concrete posture possible. Prices for network elements determined under the federal Act provide incumbents' sole compensation for turning over pieces of their networks to competitors. Actual prices, moreover, have already been set using TELRIC in dozens of regulatory proceedings around the country. The clear line between the compensation provided by these federally mandated prices and any other revenues that might be counted from state-regulated operations to make up shortfalls in the federal rates is thus sharply drawn in this context. *Cf. Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930) (where two sovereigns regulate an entity, each must set rates establishing an adequate return on the specific operations under its regulation).

c. Like the Fifth Circuit, the Eighth Circuit ultimately concluded that the court should defer under *Chevron* to the FCC's determination of the compensation incumbents would receive under the Act. It reached that result, moreover, even though incumbents had pointed out that the statutory pricing standard incorporated the constitutional standard of just compensation and that the FCC's interpretation would raise serious constitutional questions. That result was flatly erroneous and, as GTE pointed out in its petition for certiorari in the Universal Service Case, conflicts with the decisions of other circuits. *See, e.g., US WEST, Inc. v. FCC*, 182 F.3d 1224, 1231 (10th Cir. 1999) ("[I]f we determine that the FCC's [rule] presents a serious or grave constitutional question, we will owe the FCC no deference . . . ."), *cert. denied*, 120 S. Ct. 2215 (2000); *Williams v. Babbitt*, 115 F.3d 657, 662 (9th Cir. 1997) (same), *cert. denied*, 118 S. Ct. 1795 (1998); *Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445-46 (D.C. Cir. 1994) (same).

In addition, even if the FCC's construction did not raise a particularly grave constitutional question, there can be no basis for an Article III court to defer to an agency's construction of a constitutional standard. *See, e.g., Williams*, 115 F.3d at 662.

Indeed, resorting to *Chevron* deference was particularly misguided where the constitutional standard at issue was the just compensation requirement of the Takings Clause. Determining the bounds of just compensation is quintessentially an issue for the judiciary to decide. *See, e.g., Monongahela Navigation Co. v. United States*, 148 U.S. 312, 327 (1893). This case will thus allow the Court to address the same questions raised in the Fifth Circuit case relating to erroneous reliance on *Chevron* to defer to an agency interpretation of a constitutional standard. *Cf.* Pet'n for Cert. in No. 99-1244, at ii (Question Presented, part (c)), 25-27.[6]

2. This Case Presents Distinct Questions of Construction Concerning the Pricing Standard of Section 252(d)(1) That Are Worthy of Review.

Despite the similarity in the core constitutional principles underlying the challenges in both cases, the challenges to TELRIC in this case arise under a different statutory provision, and this case thus presents distinct issues of construction specific to the terms of the pricing standard in section 252(d)(1). Section 252(d)(1) commands that prices for network elements must be "based on the *cost* . . . of providing" the network element and "may include a reasonable profit" (emphasis added). Interpretation of those specific requirements will not be raised at all in the Universal Service Case.

Proper construction of those statutory terms, moreover, is critical for a federal program of vital importance to the entire telecommunications industry. As the decision to grant review

---

[6] In addition, this case will raise effectively the same claims that the FCC failed to adhere to standards of reasoned decisionmaking and acted arbitrarily and capriciously. *See* GTE Br. in No. 99-1244, at 37-47. Challenges based on faults in the FCC's rationale would actually be resolved more effectively here, because this case established the record on which the FCC based its decisions. *Cf. infra* pp. 22-23.

in *AT&T Corp. v. Iowa Utilities Board* has already shown, implementation of the local competition provisions of the 1996 Act raises questions of national significance that merit resolution by this Court even in the absence of a circuit conflict. The 1996 Act "fundamentally restructures local telephone markets," *AT&T Corp.*, 525 U.S. at 371, and thus "profoundly affects a crucial segment of the economy worth tens of billions of dollars," *id.* at 397.

The pricing standard of section 252(d)(1) is particularly central to the success of the Act. In granting entrants access to incumbents' property at cost-based rates, Congress intended to offer entrants a level playing field. But if, as the Eighth Circuit has held, the FCC may construe section 252(d)(1) to foreclose recovery of incumbents' historical costs (or to exclude consideration of the very real costs that existing subsidy systems impose on incumbents), then the Act will become a mechanism forcing incumbents to subsidize entrants by selling off parts of their networks at bargain-basement rates. The importance of the FCC's decision for proper implementation of the Act thus makes the issue presented here worthy of review in this Court. *See, e.g.*, *Eastern Enters. v. Apfel*, 524 U.S. 498, 519 (1998) (certiorari granted in absence of circuit conflict "[i]n view of the importance of the issues raised"); *National Broiler Mktg. Ass'n v. United States*, 436 U.S. 816, 820 (1978) (certiorari granted "[b]ecause of the importance of the issue for the agricultural community and for the administration of the antitrust laws"); *see also* Sup. Ct. R. 10.[7]

---

[7] The Government will also be seeking review of the Eighth Circuit's decision. *See* Brief for FCC and the United States in No. 99-1244, at 11 n.7, 35 n.29 (filed Sept. 28, 2000). If the Court grants that petition, it should certainly grant review here as well. It would make little sense to hear the Government's claim without also considering incumbents' countervailing claims bearing on the proper construction of the same statutory pricing standard in section 252(d)(1). Attempting to separate the specific question on which the FCC lost below and to consider it in isolation would artificially distort the considerations relevant to a proper construction of the Act.

This case, in fact, presents the second half of the FCC's plan for promoting local competition under the Act, the first half of which this Court already reviewed in *AT&T Corp.* The FCC's decision to base prices for network elements on the forward-looking costs of a hypothetical, most-efficient carrier and its decisions granting blanket access to incumbents' network elements formed integrated components of the FCC's overall scheme for promoting pseudo-competition. Indeed, even in *AT&T Corp.*, the implications TELRIC would have for Congress's objective of promoting genuine competition were apparent. *See AT&T Corp.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part) ("The competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any the less a regulatory process, nor any the more a competitive one."). Precisely because this case involves a complementary component of one complete program that the Court has already partially examined, the Court should grant certiorari here to complete its review of the FCC's plan for implementing the Act.

Finally, the Court's decision in the Universal Service Case will not resolve the dispute concerning proper construction of the pricing standard for network elements. The FCC's implementation of that pricing standard is now reaching this Court on the merits for the first time *four years* after the FCC promulgated its rules (and after one round of review before this Court already in *AT&T Corp.*). If the Court limits review of TELRIC to the Universal Service Case and simply remands this case in light of its decision there, the resulting delay during

further litigation in the Court of Appeals concerning application of this Court's decision, followed by further requests for review in this Court, would push off definitive construction of this critical provision of the Act for another *two years* until the spring of 2002 at the earliest. There is no need for such delay when the Court can efficiently resolve all the challenges to TELRIC now and put an end to two of the major chapters of litigation under the 1996 Act.

B. This Case Presents an Even Better Vehicle for Addressing the Challenges to TELRIC.

This case provides a far more suitable vehicle for considering challenges to TELRIC first and foremost because it arises on review of the proceeding in which the FCC actually created TELRIC. The Local Competition Order provides the FCC's original and most complete explanation of its reasons for adopting TELRIC – a discussion that extends to 50 pages. In addition, the record in this case contains the most comprehensive set of comments from interested parties criticizing forward-looking cost methodologies like TELRIC and explaining the proper measures of cost to be used under the Act – including extensive affidavits from expert economists outlining the flaws in the FCC's rationale. The Order also sets out definitively the FCC's reasons for refusing to take into account other elements of costs advocated by incumbents including historical costs, *see* Local Competition Order ¶¶ 704-707 (Pet. App. 121a-126a), and subsidy costs, *see id.* ¶¶ 712-715 (Pet. App. 128a-131a). And it provides the FCC's responses to claims that constitutional considerations demand rejecting TELRIC, *see id.* ¶¶ 733-740 (Pet. App. 145a-151a).

The Universal Service Case presents none of the same advantages. In the Universal Service Order, the FCC was effectively borrowing the cost methodology it had created and (in its view) justified in the Local Competition Order. The Universal Service Order therefore contains only an abbreviated

presentation of the rationale behind TELRIC. As a result, the briefs on the merits that GTE and other parties have already filed in the Universal Service Case often must resort to the Local Competition Order for a clear statement of the rationale behind TELRIC. *See, e.g.*, GTE Br. 9-10, 28 n.15; Br. for Southwestern Bell Tel. Co. *et al.* 11-12, 19, 23-24, 25; FCC Br. 10, 31-33, 44-45, 47-48; AT&T Br. 9-11, 46-47, 49.

The Eighth Circuit case will also allow the Court to address TELRIC in the context for which the FCC first expressly created the cost measure. TELRIC was originally developed as part of the FCC's overall plan for promoting Potemkin village competition under the Act. The FCC's approach to network-element pricing and its approach to determining the availability of network elements were complementary parts of this plan. The universal service order thus presents only a reflection of the theory for promoting competition that first underpinned TELRIC and that the FCC comprehensively developed in its Local Competition Order.

In addition, this case also presents a better vehicle for addressing challenges to TELRIC because there are no threshold issues that might preclude the Court from reaching the merits of TELRIC. In the Universal Service Case, in contrast, the FCC has asserted that, because basing federal universal service support on TELRIC determines only a "share" of the support incumbents will receive (and that the remainder will be set by state funding mechanisms that might use different cost measures), the case does not even provide the Court an opportunity to address the challenges GTE has raised to TELRIC. *See* FCC Br. in Opp. 22; FCC Br. 21-24; *see also* MCI Br. in Opp. at 22. These new FCC claims, moreover, are essentially based on modifications to the universal service scheme made in orders issued after the order under review in the Universal Service Case. The FCC's assertions thus were not briefed before the Fifth Circuit, and that court did not rule

on them. As a result, the FCC has raised a threshold issue that this Court would have to address in the first instance before it could even reach the merits of the challenges to TELRIC that it granted certiorari to resolve.

In our view, the FCC's newfound assertions about the limited effect of its Universal Service Order are without merit. But this case would allow the Court to address challenges to TELRIC without even wading into the threshold dispute the FCC has raised in the Universal Service Case. Thus, there is not even a *possibility* in this case that the Court would ultimately be unable to reach the merits of TELRIC.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1301 K Street, N.W.
Washington, D.C. 20005
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., and United States Telecom Association

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON SERVICE CORPORATION
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Verizon Entities

CHARLES R. MORGAN
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-4839

Counsel for BellSouth Corporation

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

JAMES D. ELLIS
ALFRED G. RICHTER, JR.
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
HOPE E. THURROTT
CHARLES J. SCHARNBERG
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States Telecom Association

October 4, 2000

APPENDIX CONTENTS

APPENDIX A: Pages

Opinion, *Iowa Utilities Board v. FCC*, Court of Appeals for the Eighth Circuit, 219 F.3d 744 (July 18, 2000) 1a-43a

APPENDIX B:

Excerpts from *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98 (Aug. 8, 1996)
¶¶ 618 - 740 ..... 44a-151a

APPENDIX C:

5 U.S.C. § 706 ..... 152a

APPENDIX D:

47 U.S.C. § 251 ..... 153a-161a
47 U.S.C. § 252 ..... 162a-170a

APPENDIX E:

47 C.F.R. § 50.501 ..... 171a
47 C.F.R. § 50.503 ..... 171a
47 C.F.R. § 50.505 ..... 172a-174a
47 C.F.R. § 50.507 ..... 174a-175a
47 C.F.R. § 50.509 ..... 175a-176a
47 C.F.R. § 50.511 ..... 176a-177a

APPENDIX F:

List of Additional Parties 178a-180a

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

IOWA UTILITIES BOARD, et al., Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION and
United States of America, Respondents.

No. 96-3321

Submitted: September 17, 1999
Filed: July 18, 2000

Before: WOLLMAN, Chief Judge, BOWMAN and HANSEN, Circuit Judges.

HANSEN, Circuit Judge.

These cases are before us on remand from the Supreme Court. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999). Local telephone service providers (known as "incumbent local exchange carriers" or "ILECs") and their industry associations petition

for review of the First Report and Order[1] issued by the Federal Communications Commission (FCC) which contains the FCC's findings and rules[2] pertaining to the local competition provisions of the Telecommunications Act of 1996[3] (the Act). The Act requires an ILEC to (1) permit requesting new entrants (competitors) in the ILEC's local market to interconnect with the ILEC's existing local network and, thereby, use that network to compete in providing local telephone service (interconnection); (2) provide its competitors with access to elements of the ILEC's own network on an unbundled basis (unbundled access); and (3) sell to its competitors, at wholesale rates, any telecommunications service that the ILEC provides to its customers at retail rates in order to allow the competing carriers to resell those services (resale). *See* 47 U.S.C. § 251(c)(2)- (4) (1994 ed., Supp. III).[4] Through this Act,

---

[1] *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499 (1996) (First Report and Order).

[2] The FCC's rules are codified in scattered sections of Title 47, Code of Federal Regulations. All references in this opinion to the Code of Federal Regulations are to the 1997 version.

[3] Telecommunications Act of 1996, Pub.L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of Title 47, United States Code).

[4] All references in this opinion to sections and subsections of the Telecommunications Act of 1996 in the United States Code are to the 1997 supplement unless otherwise indicated.

Congress sought "to promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies." Telecommunications Act of 1996, Pub.L. No. 104-104, purpose statement, 110 Stat. 56, 56 (1996). Challenges to the First Report and Order were consolidated in this court.

I. Background

We present a brief summary of the background of this case based upon the belief that all parties are familiar with the opinion of the Supreme Court as well as our prior opinion. In our prior opinion, *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997), we concluded, in relevant part, that (1) the FCC exceeded its jurisdiction in promulgating various pricing rules; (2) the FCC exceeded its jurisdiction in promulgating 47 C.F.R. § 51.405, regarding rural exemptions; (3) the FCC exceeded its jurisdiction in promulgating 47 C.F.R. § 51.303, regarding preexisting agreements; and (4) various unbundling rules, including the superior quality rules and the combination of network elements rule, were contrary to the Act.

The Supreme Court affirmed in part, reversed in part, and remanded. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999). The Supreme Court reversed that part of our opinion pertaining to jurisdiction and held that the FCC had jurisdiction to (1) design a pricing methodology; (2) promulgate rules pertaining to rural exemptions; and (3) promulgate rules regarding preexisting agreements. The Supreme Court also reversed our decision to vacate 47 C.F.R. § 51.315(b). The

Supreme Court did not address the part of our opinion vacating the superior quality rules, 47 C.F.R. §§ 51.305(a)(4) and 51.311(c), and the additional combination of network elements rule, 47 C.F.R. § 51.315(c)-(f).

On remand we must now review on the merits the FCC's forward-looking pricing methodology, proxy prices, and wholesale pricing provisions. The petitioners also request that the court vacate 47 C.F.R. § 51.317, regarding the identification of additional unbundled network elements, and that the court reaffirm its previous decision vacating the superior-quality rules and the additional combination of network elements rule. We also must review on the merits 47 C.F.R. § 51.405, regarding rural exemptions, and 47 C.F.R. § 51.303, pertaining to preexisting agreements.

II. Analysis

The United States Courts of Appeals have exclusive jurisdiction to review final orders of the FCC pursuant to 28 U.S.C. § 2342(1) and 47 U.S.C. § 402(a) (1994). In reviewing an agency's interpretation of a statute, we must defer to the agency only if its interpretation is consistent with the plain meaning of the statute or is a reasonable construction of an ambiguous statute. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). We will overturn an agency interpretation that conflicts with the plain meaning of the statute, *see id.*, is an unreasonable construction of an ambiguous statute, *see id.* at 844-45, 104 S.Ct. 2778, or is arbitrary and capricious. *See* 5 U.S.C. § 706 (1994); *Chevron*, 467 U.S. at 844, 104 S.Ct. 2778. In making our decision regarding reasonableness, the issue "is

not whether the Commission made the best choice, or even the choice that this Court would have made, but rather 'whether the FCC made a reasonable selection from among the available alternatives.' " *Southwestern Bell Tel. Co. v. F.C.C.*, 153 F.3d 523, 559-60 (8th Cir.1998) (quoting *MCI Telecomms. Corp. v. FCC*, 675 F.2d 408, 413 (D.C.Cir. 1982).

A. Pricing Methodology

Congress established pricing standards for the rates that may be charged by ILECs to their new local service competitors for interconnection and for the furnishing of network elements on an unbundled basis. The statute, in relevant part, states:

> (d) Pricing standards
> (1) Interconnection and network element charges
> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section--
> (A) shall be--
> (i) based on the cost (determined without reference to a rate- of-return or other ratebased proceeding) of providing the interconnection or network element (whichever is applicable), and
> (ii) nondiscriminatory, and
> (B) may include a reasonable profit.

47 U.S.C. § 252(d)(1).

The FCC promulgated various pricing rules to implement the Act. The FCC's pricing provisions that pertain to the pricing of interconnection and network elements utilize a forward-looking economic cost methodology that is based on the total element long-run incremental cost (TELRIC) of the element. These costs are to be based on an ILEC's existing wire center locations using the most efficient technology available in the industry regardless of the technology actually used by the ILEC and furnished to the competitor. *See* First Report and Order ¶ 685. State commissions are to employ TELRIC to determine the price an ILEC may charge its competitors for the right to interconnect with the ILEC and/or to use the ILEC's network elements to compete with the ILEC in providing telephone services.

The petitioners contend the TELRIC method violates the plain language and purpose of the Act and represents arbitrary and capricious decision- making. The petitioners challenge TELRIC on four grounds.

1. Hypothetical Network Standard

In its First Report and Order, the FCC explained that forward-looking methodologies, like TELRIC, consider the costs that a carrier would incur in the future for providing the interconnection or unbundled access to its network elements. *See* First Report and Order ¶ 683. These costs either can be based on the most efficient network configuration and technology currently available, or on the ILEC's existing network infrastructures. *See id.* The FCC chose an approach which it says combined the two possibilities. *See id.* ¶ 685.

Pursuant to § 252(d)(1), the FCC promulgated 47 C.F.R. § 51.505 entitled "Forward-looking economic cost." It states in part that "[t]he total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." 47 C.F.R. § 51.505(b)(1). The only nonhypothetical factor in the calculation is the use of the actual location of the ILEC's existing wire centers.

The petitioners assert that the hypothetical network standard upon which TELRIC's costs are based is contrary to the Act's plain language. Section 252(d)(1)(A)(i) requires the just and reasonable rates for network elements to be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing *the* interconnection or network element." *Id.* (emphasis added). The petitioners contend the language points inescapably to the actual costs the ILEC incurs for furnishing its existing network to the competitor either through interconnection or on an unbundled network element basis. However, the petitioners explain that the costs under the FCC's pricing methodology are those costs that would be incurred by a hypothetical carrier deploying a hypothetical network that is optimally efficient in technology and configuration. The petitioners argue that the FCC's hypothetical network standard does not reflect what they are statutorily required to furnish to their competitors and is, therefore, flatly contrary to the statute.

The respondents counter the petitioners' assertion that TELRIC costs are based on a hypothetical network. The respondents contend TELRIC does reflect the ILECs' costs

but on a predictive forward-looking basis that assumes a reasonable level of efficiency. According to the respondents, setting rates based on the use of the most efficient technology available and on the lowest cost network configuration using existing wire center locations is consistent with the statute, promotes competition, and is a reasonable application of forward-looking costs.

The intervenors in support of the FCC (the intervenors) explain that costs should be based on what any firm, including the specific ILEC whose rates are to be set, would incur in providing the network elements today. They suggest these costs should be the replacement cost of the network using the technology available today and that no firm in a competitive market would charge rates based on the cost of reproducing obsolete technology. The intervenors contend that calculating the cost of old technology with current prices defeats the purpose of using a forward-looking methodology.

We agree with the petitioners that basing the allowable charges for the use of an ILEC's existing facilities and equipment (either through interconnection or the leasing of unbundled network elements) on what the costs would be if the ILEC provided the most efficient technology and in the most efficient configuration available today utilizing its existing wire center locations violates the plain meaning of the Act. It is clear from the language of the statute that Congress intended the rates to be "based on the cost ... *of providing the interconnection or network element*," *id.* (emphasis added), not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished by the existing ILEC pursuant to Congress's

mandate for sharing. Congress was dealing with reality, not fantasizing about what might be. The reality is that Congress knew it was requiring the existing ILECs to share their existing facilities and equipment with new competitors as one of its chosen methods to bring competition to local telephone service, and it expressly said that the ILECs' costs of providing *those* facilities and *that* equipment were to be recoverable by just and reasonable rates. Congress did not expect a new competitor to pay rates for a "reconstructed local network," First Report and Order ¶ 685, but for the existing local network it would be using in an attempt to compete.

It is the cost to the ILEC of providing its existing facilities and equipment either through interconnection or by providing the specifically requested existing network elements that the competitor will in fact be obtaining for use that must be the basis for the charges. The new entrant competitor, in effect, piggybacks on the ILEC's existing facilities and equipment. It is the cost to the ILEC of providing that ride on those facilities that the statute permits the ILEC to recoup. This does not defeat the purpose of using a forward-looking methodology as the intervenors assert. Costs can be forward-looking in that they can be calculated to reflect what it will cost the ILEC in the future to furnish to the competitor those portions or capacities of the ILEC's facilities and equipment that the competitor will use including any system or component upgrading that the ILEC chooses to put in place for its own more efficient use. In our view it is the cost to the ILEC of carrying the extra burden of the competitor's traffic that Congress entitled the ILEC to recover, and to that extent, the FCC's use of an incremental cost approach does no violence to the statute. At bottom,

however, Congress has made it clear that it is the cost of providing the actual facilities and equipment that will be used by the competitor (and not some state of the art presently available technology ideally configured but neither deployed by the ILEC nor to be used by the competitor) which must be ascertained and determined.

Consequently, we vacate and remand to the FCC rule 51.505(b)(1).

2. Use of a Forward-looking Methodology

The petitioners contend that the FCC's use of its forward-looking TELRIC methodology, which denies the ILECs recovery of their historical costs, is contrary to the express terms of the Act and is unreasonable. The petitioners state that the term "cost" plainly refers to historical cost and that the juxtaposition of "cost" in § 252(d)(1)(A)(i) with "profit" in § 252(d)(1)(B) confirms this. They refer to the discussion of profit in paragraph 699 of the First Report and Order as support for their proposition that if profit must be read in an accounting sense, then so too must cost. In addition, they assert the FCC failed to provide an adequate explanation for its rejection of historical costs and that an agency is not allowed to change ratemaking methodologies without cogently explaining why the change is being made.

The respondents argue the term "cost" is an elastic term that can be construed to mean either historical or forward-looking costs and that the FCC's interpretation of cost as forward-looking is reasonable. They clarify the discussion in the First Report and Order regarding profit. They explain that the FCC found that a normal profit, which

TELRIC is designed to yield, represents a "reasonable profit" within the meaning of the statute and that the FCC has not construed profit to mean accounting profit. The respondents also argue the FCC explained in detail its decision to use forward-looking costs and that the decision was reasonable based on the new competitive objectives of the 1996 Act. The intervenors agree with the respondents that the term "cost" imposes no clear limits on the FCC's authority to establish a ratemaking methodology, and according to their argument, it is in these circumstances that an agency is entitled to deference.

We respectfully disagree with the petitioners' contention that cost, as it is used in the statute, means historical cost. The statute simply states that rates "shall be based on the cost ... of providing the interconnection or network element." 47 U.S.C. § 252(d)(1)(A). We conclude the term "cost," as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context. We agree with the assessment that "the word 'cost' is a chameleon, capable of taking on different meanings, and shades of meaning, depending on the subject matter and the circumstances of each particular usage." *Strickland v. Commissioner, Maine Dept. of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995), *cert. denied*, 516 U.S. 850, 116 S.Ct. 145, 133 L.Ed.2d 91 (1995).

The FCC has the authority to make rules to fill any gap in the Act left by Congress, provided the agency's construction of the statute is reasonable. *See Chevron*, 467 U.S. at 843, 104 S.Ct. 2778. Likewise, "Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency." *AT&T Corp.*,

525 U.S. at 397, 119 S.Ct. 721 (citation to *Chevron* omitted). Forward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the Act. The Seventh Circuit, for example, explained, "[I]t is current and anticipated cost, rather than historical cost that is relevant to business decisions to enter markets ... historical costs associated with the plant already in place are essentially irrelevant to this decision since those costs are 'sunk' and unavoidable and are unaffected by the new production decision." *MCI Communications v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1116-17 (7th Cir. 1983), *cert. denied*, 464 U.S. 891, 104 S.Ct. 234 (1983). Here, the FCC's use of a forward-looking cost methodology was reasonable. The FCC sought comment on the use of forward-looking costs and concluded that forward-looking costs would best ensure efficient investment decisions and competitive entry. *See* First Report and Order ¶ 1705. It is apparent that the FCC explained in detail its reason for selecting a forward-looking cost methodology to implement the new competitive goals of the Act, and any past rejection of forward-looking methodologies was made in a monopoly, rather than a competitive, environment. *See* First Report and Order ¶¶ 618-711.

Additionally, we are unpersuaded by the petitioners' discussion of the juxtaposition of the word "profit" with "cost" in the statute. The FCC did not interpret profit as accounting[5] profit as the petitioners contend. The First Report

---

[5] Accounting profit equals the difference between total revenue and explicit costs. Explicit costs are those costs incurred when a monetary payment is made. Accounting profit is typically higher than economic profit because accounting profit only subtracts explicit costs rather than the total opportunity costs. *See* ROGER A. ARNOLD, ECONOMICS 484-85 (2d ed.1992).

and Order discusses only two types of profit: economic[6] and normal.[7] *See* First Report and Order ¶ 699. The FCC interpreted the word "profit" in the statute to mean "normal profit." The FCC found that TELRIC provides for a "normal" profit and that level of profit is reasonable within the meaning of the statute. Section 252(d)(1)(B) states only that the rates paid for either interconnection or furnishing unbundled access "may include a reasonable profit." The use of the word "may" indicates that the inclusion of a reasonable profit is not mandatory but permitted. Additionally, nothing in the phrase "may include a reasonable profit" suggests "cost" must mean historical costs. A "profit" can be made whether a historical cost or forward-looking cost methodology is used. We reiterate that a forward- looking cost calculation methodology that is based on the incremental costs that an ILEC actually

---

[6] Economic profit equals the difference between total revenue and total opportunity cost, including both explicit and implicit costs. Implicit costs represent the value of resources used for which no monetary payment is made. *See id.* Economic profit is also referred to as supranormal profit. *See* First Report and Order ¶ 699.

[7] Normal profit is achieved when a company earns revenue that is equal to its total opportunity costs. This is the level of profit needed for a company to cover all of its opportunity costs. Normal profit is the same as zero economic profit. *See* ARNOLD, *supra* note 5, at 485.

incurs or will incur in providing the interconnection to its network or the unbundled access to its specific network elements requested by a competitor will produce rates that comply with the statutory requirement of § 252(d)(1) that an ILEC recover its "cost" of providing the shared items.

3. Effect of Universal Service Subsidies

The petitioners submit that the failure to include the costs imposed by the government mandated subsidies in network element prices would frustrate the Act's objectives by forcing the ILECs to bear a disproportionate share of the universal service burdens. They explain that when an incumbent carrier provides to a competitor the network elements needed to serve a business customer, the costs to the incumbent not only include the costs of operating the particular network elements furnished but also the loss of that customer's contribution to support lower rates for others. The loss of that contribution, the petitioners argue, must be included in the determination of the rates charged the competitor for unbundled access to the ILEC's network elements.

The respondents and intervenors assert that allowing the ILECs to include the costs of universal service subsidies in its rates would violate the Act. They argue § 252(d)(1) requires rates to reflect the costs of providing the network elements, not the costs of universal service subsidies. Including those costs, according to the respondents, would violate that section of the Act. The respondents cite two decisions in which we concluded that the costs of universal services subsidies should not be included in the costs of providing the network elements. *See Competitive Telecomms.*

Ass'n v. F.C.C., 117 F.3d 1068, 1074-75 (8th Cir. 1997); *Southwestern Bell Tel. Co.*, 153 F.3d at 540.

In accordance with our previous opinions, we maintain our view that the costs of universal service subsidies should not be included in the costs of providing the network elements. Section 252(d)(1)(A)(1) requires rates to be cost-based. Universal service charges are not based on the actual costs of providing interconnection or the requested network element. *See Competitive Telecomms.*, 117 F.3d at 1073. "[P]ayment of cost-based rates represents full compensation to the incumbent LEC for use of the network elements that carriers purchase." *Southwestern Bell*, 153 F.3d at 540 (quoting *In re Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Transport Rate Structure and Pricing; End User Common Line Charges*, 12 FCC Rcd 15982 (1997) ¶ 337). Including the costs of universal service subsidies would allow for double recovery. *See id.*

4. Takings Argument

The petitioners contend the use of the TELRIC method to set rates raises a serious Fifth Amendment takings issue that the statute should be construed to avoid. The petitioners challenge the pricing rules as mandating invalid confiscatory rates. The petitioners insist the statute must be read so that an ILEC receives just and reasonable compensation in the constitutional sense for the services it provides to its competitors.

The respondents argue that the claim that the use of TELRIC will constitute a taking is not ripe for judicial

consideration because, at this point, it is unknown whether the rates established under TELRIC will constitute just and reasonable compensation. In addition, the intervenors point out that TELRIC compensates the ILECs for the present market value of the property taken which is all that is constitutionally required for just and reasonable compensation.

Because we have vacated 47 C.F.R. § 51.505(b)(1), we have some doubt that we need to address the argument that TELRIC also violates the Constitution. Our remand to the FCC of the TELRIC rule should result in a new rule for determining the compensation that the ILECs will receive for the new competitor's use of the ILEC's property--a rule that should accurately determine the actual costs to the ILEC of furnishing its network (either by interconnection or on an unbundled element basis) to its competitors together with a permitted reasonable profit. Whether the new rule will result in rates that do not provide just and reasonable compensation cannot be foretold. However, in the event our view of TELRIC's statutory invalidity turns out to be incorrect, and to avoid as best we can another remand, we proceed further with the petitioners' constitutional assertions.

In our earlier opinion we determined that the ILECs' claims that the FCC's unbundling rules constituted an unconstitutional taking were not ripe for adjudication. *See Iowa Utils. Bd.*, 120 F.3d at 818. We did so principally on the basis that the rates for the unbundled access were to be set by the state commissions, that the actual rates were largely yet unknown, and that the Act provided for a mechanism (arbitration before the state commissions and review in federal district court) to determine what the just and

reasonable rates would be in individual cases. That ripeness conclusion was not attacked in the Supreme Court. While we recognize that the argument made here (that TELRIC itself, because it is based on a hypothetical network using the most efficient technology available which bears little or no resemblance to the ILEC's property which will be actually made available to competitors, must result in rates that are neither just nor reasonable, and confiscatory in the constitutional sense) is not the same one we addressed in our earlier opinion, we conclude for many of the same reasons we expressed before, *see id.*, that the present takings claim is not ripe for review.[8]

The Constitution protects public utilities from rates which are "so unjust as to be confiscatory." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307, 109 S.Ct. 609, 102 L.Ed.2d 646 (1989). However, a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself. "It is not theory but the impact of the rate order which counts." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S.Ct. 281, 88 L.Ed. 333 (1944). Until the actual rates are established, we cannot conclude whether the impact of TELRIC driven rates will

---

[8] We note, with no small amount of interest, that the Supreme Court has granted certiorari to review the Fifth Circuit's decision in *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), where the Fifth Circuit noted that the use of a forward-looking cost model to determine universal service subsidies did not result in an unconstitutional taking. *GTE Service Corp. v. FCC*,120 S.Ct. 2214, 147 L.Ed.2d 247 (2000).

constitute a taking. "It is not enough that a party merely speculates that a government action will cause harm." *Alenco Communications, Inc. v. F.C.C.*, 201 F.3d 608, 624 (5th Cir. 2000). We do not need to disregard *Chevron* deference and interpret the statute in accordance with the petitioners' views in order to avoid an unconstitutional taking in this instance. The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. *See United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29, 106 S.Ct. 455, 88 L.Ed.2d 419 (1985). In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. *See id.* at 128, 106 S.Ct. 455. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates have been determined and applied, the constitutional claim is not ripe. *See Duquesne*, 488 U.S. at 317, 109 S.Ct. 609 (Scalia, White, and O'Connor, JJ., concurring) (noting that the Constitution looks to the consequences produced rather than the technique employed).

B. Wholesale Rates

Section 252(d)(3) of the Act provides that state commissions "shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." Pursuant to this section, the FCC promulgated 47 C.F.R. § 51.607 which excludes "avoided retail costs" from wholesale rates. "Avoided retail costs" are defined by the FCC as "those costs that reasonably can be avoided when an incumbent LEC

provides a telecommunications service for resale at wholesale rates to a requesting carrier." 47 C.F.R. § 51.609(b).

The petitioners challenge the FCC's interpretation of the term "avoided retail costs." The petitioners contend § 252(d)(3) plainly requires wholesale rates to reflect the ILECs' retail rates less those costs that an ILEC actually avoids when it loses its retail customers to a reselling competitor. However, under the FCC's definition of "avoided retail costs," the petitioners argue the FCC requires them to exclude all retailing costs rather than only those costs that an ILEC actually avoids. The petitioners state that many costs associated with retailing are fixed and will not begin to decline initially nor will the costs decline proportionately to the number of customers lost to the reseller. The petitioners explain the phrase "will be avoided" in § 252(d)(3) means "actually avoided" because otherwise the wholesale discount given the reseller would be inflated.

The respondents counter that the phrase "will be avoided" is ambiguous and that the FCC reasonably interpreted the language of the statute. The intervenors explain that the ILECs avoid incurring any retailing costs when engaging in wholesale transactions, and even if certain retailing costs are fixed, the ILECs would still incur only those costs that arose in connection with the ILECs' retailing activities. The respondents state that making competitors pay for a portion of the ILECs' retailing costs, even though the new entrant is not the cause of those retail costs, would result in the new entrants subsidizing the ILECs' retail offerings while still having to pay the new entrants' own retailing costs.

We agree with the petitioners that the phrase "will be avoided" refers to those costs that the ILEC will actually avoid incurring in the future, because of its wholesale efforts, not costs that "can be avoided." The verb "will" is defined, in part, as "a word of certainty." BLACK'S LAW DICTIONARY 1598 (6th ed. 1990). Whereas, the verb "can" is "[o]ften used interchangeably with 'may,' " *id.* at 206, and may is a word "of speculation and uncertainty." *Id.* at 1598. The language of the statute is clear. Wholesale rates shall exclude "costs that will be avoided by the local exchange carrier." 47 U.S.C. § 252(d)(3). The plain meaning of the statute is that costs that are actually avoided, not those that could be or might be avoided, should be excluded from the wholesale rates.

If the Congress had meant the standard to be one of reasonable avoidability, it could have easily said so. We note that Congress's starting point in § 252(d)(3) is the retail rates the ILEC charges its subscribers for the same service the new competitor (who wants to enter the market by reselling) has requested be furnished to it. From those retail rates, the ILEC's costs that "will be avoided" by furnishing those services to the competitor are to be excluded. The statute recognizes that the ILEC will itself remain a retailer of telephone service with its own continuing costs of providing that retail telephone service. The FCC's rule treats the ILEC as if it were strictly a wholesaler whose sole business is to supply local telephone service in bulk to new purveyors of retail telephone service. Under the statute as it is written, it is only those continuing costs of providing retail telephone service which will be avoided by selling to the competitor the services it requests which are to be excluded. The FCC's rule is contrary to the statute.

Consequently, we vacate and remand rule 51.609.

C. Proxy Prices

The FCC established proxy prices to be used for interconnection and network element charges, wholesale rates, and the rates for termination and transport. The state commissions are to use these proxy prices if they do not use the provided ratemaking method to establish rates. The proxy prices consist of upper limits higher than which the rates set by the state commissions shall not go.

The petitioners argue the proxy prices should be vacated for three reasons. First, the petitioners state that the respondents expressly disavowed the proxy prices before the Supreme Court in order to support the FCC's position that it was not trying to set specific prices, but rather it was merely designing a pricing methodology. Therefore, the FCC, according to the petitioners, is judicially estopped from trying to revive the proxy prices now. Second, the petitioners contend the proxy prices should be vacated because they are based on the unlawful TELRIC method and employ the impermissible definition of "avoided retail costs." Third, the petitioners argue the proxy prices were developed using unreliable cost models and, as a result, are arbitrary and capricious.

The respondents counter that the petitioners' challenge to the proxy prices is not subject to review because the proxy prices are not binding on the states. The respondents contend that states may elect to use the proxy prices, but the states are not required to use them. The respondents insist that this court has jurisdiction to review only final orders of the FCC,

and the proxy prices are not final orders because they do not impose an obligation on the states. The intervenors add that substantial deference should be accorded to the FCC because the issue concerns interim relief, citing *Competitive Telecommunications Association v. F.C.C.*, 117 F.3d 1068, 1073-75 (8th Cir. 1997).

We agree with the petitioners that the respondents are estopped from trying to now revive the proxy prices. "The doctrine of judicial estoppel prohibits a party from taking inconsistent positions in the same or related litigation." *Hossaini v. Western Missouri Med. Ctr.*, 140 F.3d 1140, 1142 (8th Cir. 1998). Judicial estoppel is invoked "to protect the integrity of the judicial process." *Id.* at 1143. The FCC represented to the Supreme Court that it was not establishing rates and depriving the state commissions of their role in implementing the Act. *See* Reply Br. for Federal Pet'rs at 7, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999) 1998 WL 396961 (Nos. 97-826, 97-829, 97-830, 97-831, 97-1075, 97-1087, 97-1099, and 97-1141). The FCC emphasized that it was merely providing a methodology for state commissions to use in completing the "critical and complex task of determining the economic costs of an efficient telephone network." *Id.* The FCC dismissed the proxy prices as "designed for a past period in which no cost studies could have been made available to the state commissions. They have no relevance to this case." *Id.* at 7 n. 5.

We are not persuaded by the FCC's explanation to this court of its position before the Supreme Court. The respondents explain that the proxy prices were not relevant to the ILECs' claim before the Supreme Court that the pricing

rules intruded on the states' role in establishing rates because the proxy prices were optional. The First Report and Order very clearly commands the use of the proxy prices by directing that "a state commission *shall* use [default proxies] ... in the period before it applies the pricing methodology." First Report and Order ¶ 619 (emphasis added). Additionally, rule 51.503(b) states that the ILECs' rates for its elements "*shall* be established" using either TELRIC or the proxy prices. *See* 47 C.F.R. § 51.503(b) (emphasis added). The word "shall" is language of a mandatory nature. *Clark v. Brewer*, 776 F.2d 226, 230 (8th Cir.1985). It is clear from the language of the First Report and Order, as well as the rules, that the state commissions are to use the proxy prices until the state commissions have established their own rates using the TELRIC method. The use of the proxy prices until such time is not optional.

The Supreme Court held that the FCC "has jurisdiction to design a pricing methodology." *AT&T Corp.*, 525 U.S. at 385, 119 S.Ct. 721. However, the FCC does not have jurisdiction to set the actual prices for the state commissions to use. Setting specific prices goes beyond the FCC's authority to design a pricing methodology and intrudes on the states' right to set the actual rates pursuant to § 252(c)(2). Following the Supreme Court's opinion, we now agree with the FCC that its role is to resolve "general methodological issues," and it is the state commission's role to exercise its discretion in establishing rates. Br. for Federal Pet'rs at 26-27, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 119 S.Ct. 721, 142 L.Ed.2d 835 (1999).

The proxy prices are also infirm because they rely on the hypothetical most efficient carrier rationale which we

have found to be violative of the Act, *ante* at 5-8, and because they rely on the erroneous definition of "avoided retail costs."

We conclude the proxy prices cannot stand and, for the foregoing reasons, vacate rules 51.513, 51.611, and 51.707.

D. Unbundling Rules

The FCC issued numerous rules to implement the ILECs' duties to provide unbundled access to their network elements under subsection 251(c)(3). Many of these rules were previously challenged. In light of the Supreme Court's opinion, we revisit three of the unbundling rules.

1. Identification of Additional Unbundled Network Elements

The Supreme Court vacated 47 C.F.R. § 51.319 which required the ILECs to provide requesting carriers with unbundled access to a minimum of seven network elements so long as access was "necessary" and failure to provide the access would "impair" the competitors' ability to provide services. The Supreme Court vacated 47 C.F.R. § 51.319 because the FCC's interpretation of the "necessary" and "impair" standard was too broad and unreasonable. *See AT&T Corp.*, 525 U.S. at 388-92, 119 S.Ct. 721.

The ILECs request that we now vacate rule 51.317 because it utilizes the same "necessary" and "impair" standard of rule 51.319. The Supreme Court did not specifically address the validity of rule 51.317. This court previously upheld the "necessary" and "impair" standard, but

we vacated the portion of rule 51.317 that created the presumption that a network element must be unbundled if it is technically feasible to do so.

The respondents concede that rule 51.317 must be remanded to the FCC as a result of the Supreme Court's opinion. *See* Resp'ts' Br. at 87 n. 42. Therefore, we vacate rule 51.317 without any further discussion.

2. Superior Quality Rules

In our previous opinion, we vacated 47 C.F.R. §§ 51.305(a)(4) and 51.311(c), collectively known as the superior quality rules. These rules require an ILEC to provide, upon request, interconnection and unbundled network elements that are superior in quality to that which the ILEC provides to itself. The Supreme Court did not address these rules.

The petitioners ask us to reaffirm our previous decision vacating the superior quality rules. They contend the Supreme Court's decision did not affect our conclusion that the superior quality rules violated the Act because the FCC did not seek a review of our prior decision vacating these rules.

The respondents argue that the Supreme Court affirmed the FCC's general authority to adopt rules implementing the Act and that under this general authority the superior quality rules are valid. The intervenors agree and explain that because nothing in the Act forecloses the superior quality rules, the rules should be reinstated.

We again conclude the superior quality rules violate the plain language of the Act. We further conclude that nothing in 47 U.S.C. §§ 154(i), 201(b), or 303(r) gives the FCC the power to issue regulations contrary to the plain language of the Act. As we were correctly reminded at oral argument that this court is not a "super FCC," neither is the FCC an alter ego Congress free to change the words of a statute from "at least equal in quality" to "superior in quality" when it exercises its rule-making power. Subsection 251(c)(2)(C) requires the ILECs to provide interconnection "that is at least equal in quality to that provided by the local exchange carrier to itself...." Nothing in the statute requires the ILECs to provide superior quality interconnection to its competitors. The phrase "at least equal in quality" establishes a minimum level for the quality of interconnection; it does not require anything more. We maintain our view that the superior quality rules cannot stand in light of the plain language of the Act for all the reasons we previously expressed. *See Iowa Utils. Bd.*, 120 F.3d at 812-13. We also note that it is self-evident that the Act prevents an ILEC from discriminating between itself and a requesting competitor with respect to the quality of the interconnection provided.

3. Additional Combinations Rule

In our previous opinion, we also vacated 47 C.F.R. § 51.315(c)-(f), the additional combinations rule. This rule requires an ILEC to perform the functions necessary to combine unbundled network elements in any technically feasible manner. Although the Supreme Court reversed our decision to vacate 47 C.F.R. § 51.315(b), prohibiting the ILECs from separating requested network elements that are

already combined, the Supreme Court did not address subsections (c)-(f).

The petitioners request that we reaffirm our prior decision vacating the additional combinations rule. The petitioners state that the Supreme Court's decision to reinstate 51.315(b) does not call into question this court's decision to vacate 51.315(c)-(f). The petitioners explain 51.315(b) is different because it prohibited ILECs from separating previously combined network elements over the objection of the requesting carrier. The additional combinations rule contained in subsections (c)-(f), on the other hand, requires the ILECs to combine their own network elements in new ways or with elements provided by the requesting carriers. They argue the additional combinations rule violates the Act.

In addition to the respondents' argument regarding the general rulemaking authority of the FCC, they assert this court's decision to vacate rules 51.315(c)-(f) was predicated on language rejected by the Supreme Court when it reinstated rule 51.315(b). In reinstating subsection (b), the Supreme Court emphasized the ambiguous nature of § 251(c)(3) regarding the separation of leased network elements. *See AT&T Corp.*, 525 U.S. at 395, 119 S.Ct. 721. Because of this ambiguity, the Supreme Court concluded, subsection (b) is rationally based on the nondiscrimination language in § 251(c)(3). *See id.* The respondents rely on the same nondiscrimination language to support subsections (c)-(f) because without these subsections, they argue, new entrants would incur higher costs for unbundled network elements than the ILECs incur. The intervenors agree that the policy concerns of ensuring against an anticompetitive practice not

only support 47 C.F.R. § 51.315(b) but also subsections (c)-(f).

We are not persuaded by the respondents' contention that the Supreme Court's reinstatement of rule 51.315(b) affects our decision to vacate subsections (c)-(f). Nor do we agree with the Ninth Circuit that the Supreme Court's opinion undermined our rationale for invalidating the additional combinations rule. *See U.S. West Communications v. MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999), *cert. denied*, 68 U.S.L.W. 3669, 120 S.Ct. 2741 (U.S. June 29, 2000). The Ninth Circuit misinterpreted our decision to vacate subsections (c)-(f). We did not, as the Ninth Circuit suggests, employ the same rationale for invalidating subsections (c)-(f) as we did in invalidating subsection (b). *See MCI Telecomms. v. U.S. West*, 204 F.3d 1262, 1268 (9th Cir. 2000) ("The Eighth Circuit invalidated Rules 315(c)-(f) using the same rationale it employed to invalidate Rule 315(b). That is, the Eighth Circuit concluded that requiring combination was inconsistent with the meaning of the Act because the Act calls for 'unbundled' access.") Rather, the issue we addressed in subsections (c)-(f) was *who* shall be required to do the combining, not whether the Act prohibited the combination of network elements. *See Iowa Utils. Bd .*, 120 F.3d at 813.

Rule 51.315(b) prohibits the ILECs from separating previously combined network elements before leasing the elements to competitors. The Supreme Court held that 51.315(b) is rational because "[section] 251(c)(3) of the Act is ambiguous on whether leased network elements may or must be separated." *AT&T Corp.*, 525 U.S. at 395, 119 S.Ct. 721. Therefore, under the second prong of Chevron, the Supreme

Court concluded 51.315(b) was a reasonable interpretation of an ambiguous statute.

Unlike 51.315(b), subsections (c)-(f) pertain to the combination of network elements. Section 251(c)(3) specifically addresses the combination of network elements. It states, in part, "An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunication service." Here, Congress has directly spoken on the issue of who shall combine previously uncombined network elements. It is the requesting carriers who shall "combine such elements." It is not the duty of the ILECs to "perform the functions necessary to combine unbundled network elements in any manner" as required by the FCC's rule. *See* 47 C.F.R. § 51.315(c). We reiterate what we said in our prior opinion: "[T]he Act does not require the incumbent LECs to do *all* the work." *Iowa Utils. Bd.*, 120 F.3d at 813. Under the first prong of Chevron, subsections (c)-(f) violate the plain language of the statute. We are convinced that rules 51.315(c)-(f) must remain vacated.

E. Rural Exemptions

Congress enacted § 251(f) to relieve the small and rural ILECs from some of the obligations imposed by other subsections of § 251. The FCC promulgated 47 C.F.R. § 51.405 to establish standards that the state commissions must follow in determining whether the small and rural ILECs are entitled to the exemption, suspensions, or modifications set forth in § 251(f).

The petitioners contend rule 51.405 cannot be reconciled with the language of the statute. They challenge the rule on three grounds. First, they argue the rule eliminates two of the three prerequisites that must be satisfied before a state commission may terminate an exemption. Second, they disagree with the limitation the rule places on the statutory phrase "unduly economically burdensome." Third, they suggest that the rule impermissibly shifts the burden of proof in exemption proceedings.

1. Prerequisites for Terminating an Exemption

Section 251(f)(1)(A) explains that a state commission may terminate an exemption for a rural telephone company if a request for interconnection, services, or network elements "is not unduly economically burdensome, is technically feasible, and is consistent with section 254 of this title (other than subsections (b)(7) and (c)(1)(D) thereof)." The FCC promulgated 47 C.F.R. § 51.405 pursuant to § 251(f). The rule requires the ILECs to offer evidence that the application of the requirements under § 251(c) "would be likely to cause undue economic burden beyond the economic burden that is typically associated with efficient competitive entry" in order to justify exemption. 47 C.F.R. § 51.405(c).

The petitioners contend the rule is invalid because it alters the statutorily-mandated criteria that must be met in order for a state commission to terminate a rural ILEC's exemption. The petitioners point out that rule 51.405 refers only to the "unduly economically burdensome" prerequisite for termination rather than the above-mentioned three criteria.

The respondents argue that the rule does not eliminate any statutory criteria regarding rural exemptions. The respondents explain it was not the FCC's intent, nor was it within the FCC's power, to eliminate any statutory requirements. The respondents suggest that state commissions will look to the statute itself, in addition to the FCC's rule, when implementing § 251(f). They further claim that the FCC has stated in a later order that rule 51.405(c) "does not in any way affect a state's responsibility to consider all three of the factors set forth in section 251(f)(1)(A)," citing to an order entered when the Rural Telephone Coalition sought a stay of rule 51.405(c). *See In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 20166 (1996) ¶ 15.

We agree with the petitioners that the rule impermissibly disregards two of the three statutory requirements that must be met before a state commission can terminate an exemption. A state commission looking at rule 51.405(c) would conclude that if a rural ILEC had failed to show an undue economic burden, the exemption must be terminated, regardless of the existence of the ILEC's companion defenses of technical infeasibility and/or inconsistency with § 254 of the Act. A rule that permits such a result represents an arbitrary and unreasonable interpretation of the governing statute.

2. Undue Economic Burden

Rule 51.405 also refers to the statutory requirement that a request for interconnection, unbundled elements, or retail services for resale must not cause an undue economic burden in order to justify termination of an exemption under §

251(f)(1) or to justify the denial of a petition for suspension or modification under § 251(f)(2). The rule interprets the statutory phrase "unduly economically burdensome" as "undue economic burden beyond the economic burden that is typically associated with efficient competitive entry." 47 C.F.R. § 51.405(c), (d).

The petitioners argue that the rule's interpretation of the statutory language is unreasonable because it does not allow state commissions to consider the total actual economic burden that competitive entry could impose on a small or rural ILEC. The petitioners explain that the phrase "unduly economically burdensome" indicates Congress intended state commissions to consider any type of economic burden that might be imposed by such a request, including those burdens associated with efficient entry.

The respondents assert that the FCC interpreted "unduly economically burdensome" to refer to something more than the economic burden that commonly or ordinarily occurs upon efficient competitive entry because otherwise exemption, suspension, or modification would be virtually automatic. The respondents submit that Congress did not intend to preclude competitive entry into small or rural markets; rather Congress intended to protect the small or rural ILECs from only those § 251(b) or § 251(c) requirements that might be unfair or inappropriate.

We agree with the petitioners that the FCC has unreasonably interpreted the phrase "unduly economically burdensome." We owe no deference to an agency's interpretation that would "frustrate the congressional policy underlying a statute." *Bureau of ATF v. Fed. Labor Relations*

Auth., 464 U.S. 89, 97, 104 S.Ct. 439, 78 L.Ed.2d 195 (1983) (quoting *NLRB v. Brown*, 380 U.S. 278, 291-92, 85 S.Ct. 980, 13 L.Ed.2d 839 (1965)). In the Act, Congress sought both to promote competition and to protect rural telephone companies as evidenced by the congressional debates. *See* 142 CONG.REC. S687-01 (Feb. 1, 1996) (statements by Sen. Hollings and Sen. Burns); 142 CONG.REC. H1145-06 (Feb. 1, 1996) (statement by Rep. Orton). It is clear that Congress intended that all Americans, including those in sparsely settled areas served by small telephone companies, should share the benefit of the lower cost of competitive telephone service and the benefits of new telephone technologies, which the Act was designed to provide. It is also clear that Congress exempted the rural ILECs from the interconnection, unbundled access to network elements, and resale obligations imposed by § 251(c), unless and until a state commission found that a request by a new entrant that the ILEC furnish it any of § 251(c)'s methods to compete in the rural ILEC's market is (1) not unduly economically burdensome, (2) technically feasible, and (3) consistent with § 254. *See* 47 U.S.C. § 251(f)(1). Likewise, Congress provided for the granting of a petition for suspension or modification of the application of the requirements of § 251(b) or (c) if a state commission determined that such suspension or modification is necessary to avoid (1) a significant adverse economic impact, (2) imposing a requirement that is unduly economically burdensome, and (3) imposing a requirement that is technically infeasible; and is consistent with the public interest, convenience, and necessity. *See* 47 U.S.C. § 251(f)(2).

There can be no doubt that it is an economic burden on an ILEC to provide what Congress has directed it to

provide to new competitors in § 251(b) or § 251(c). Because the small and rural ILECs, while they may be entrenched in their markets, have less of a financial capacity than larger and more urban ILECs to meet such a request, the Congress declared that their statutorily- granted exemption from doing so should continue unless the state commission found all three prerequisites for terminating the exemption, or determined that all prerequisites for suspension or modification were met in order to grant an ILEC affirmative relief. It is the full economic burden on the ILEC of meeting the request that must be assessed by the state commission. The FCC's elimination from that assessment of the "economic burden that is typically associated with efficient competitive entry" substantially alters the requirement Congress established. By limiting the phrase "unduly economically burdensome" to exclude economic burdens ordinarily associated with competitive entry, the FCC has impermissibly weakened the broad protection Congress granted to small and rural telephone companies. We have found no indication that Congress intended such a cramped reading of the phrase. If Congress had wanted the state commissions to consider only that economic burden which is in excess of the burden ordinarily imposed on a small or rural ILEC by a competitor's requested efficient entry, it could easily have said so. Instead, its chosen language looks to the whole of the economic burden the request imposes, not just a discrete part.

Nor do we think the consideration of the whole economic burden occasioned by the request will result in state commissions "automatically" continuing the exemption, or "automatically" granting a petition for suspension or modification. In making their determination of "unduly economically burdensome," the state commissions will

undoubtedly take into their judgment the fact that the ILEC will be paid for the cost of meeting the request and may also receive a reasonable profit pursuant to § 252(d). Subsections (c) and (d) of rule 51.405 are an unreasonable interpretation of the statute's requirement that a § 251(b) or § 251(c) request made by a competitor must not be "unduly economically burdensome" to the small or rural ILEC.

3. Burden of Proof

Rule 51.405 also requires the rural ILEC to offer evidence to the state commission to prove that it is entitled to a continuing exemption. The rule states, "Upon receipt of a bona fide request for interconnection, services, or access to unbundled network elements, a rural telephone company must prove to the state commission that the rural telephone company should be entitled, pursuant to section 251(f)(1) of the Act, to continued exemption from the requirements of section 251(c) of the Act." 47 C.F.R. § 51 .405(a).

The petitioners contend the FCC has improperly placed the burden of justifying a continued exemption on the ILECs. The petitioners discuss the language in 47 U.S.C. § 251(f)(1)(A), which states "[s]ubsection (c) of this section shall not apply to a rural telephone company until (i) such company has received a bona fide request for interconnection, services, or network elements...." This language, they explain, indicates that the ILECs are automatically exempt from subsection (c) until a request has been made, and once a request is made, the burden is on the party making the request to prove that the request is not unduly economically burdensome, is technically feasible, and is consistent with § 254. They also assert the burden of proof lies with the

proponent of the order according to the Administrative Procedure Act. *See* 5 U.S.C. § 556(d) (1994).

The respondents argue it was reasonable to place the burden on the rural ILECs because the default rule is for the state commission to deny the exemption unless the state commission affirmatively finds a reason to continue the exemption. The respondents rely on the Senate conference report on the Act which explains that a state commission must rule on the continuation of an exemption within 120 days, "and, if no exemption is granted," then the state commission must establish a schedule for compliance. S.CONF.REP. No. 104-230, at 122 (1996). The respondents emphasize the word "granted" implies that a state commission will only grant an exemption if there is a specific reason to do so.

We agree with the petitioners that the rule impermissibly places the burden of proof on the ILECs. The statute states that the requirements of § 251(c) "shall not apply to a rural telephone company *until*" a request has been made. 47 U.S.C. § 251(f)(1)(A) (emphasis added). The use of the word "until" suggests that the rural telephone companies have a continuing exemption that is only terminated once a bona fide request is made, provided the request is not unduly economically burdensome, is technically feasible, and is consistent with § 254. Although the conference report refers to state commissions granting an exemption, the language of a conference report does not trump the language of a statute. *See Sierra Club v. Clark*, 755 F.2d 608, 615 (8th Cir. 1985). The language of the statute uses the word "terminate" not "grant." *See* 47 U.S.C. § 251(f)(1)(B). The plain meaning of the statute requires the party making the request to prove that the request meets the

three prerequisites to justify the termination of the otherwise continuing rural exemption.

For the foregoing reasons, we vacate rule 51.405(a), (c), and (d).

F. Preexisting Agreements

Congress enacted § 252 of the Act to establish procedures for state commissions to approve agreements between ILECs and competing telecommunication carriers arrived at through negotiation or arbitration. Section 252(a) requires agreements entered into pursuant to § 251(c)(1)'s duty to negotiate to be submitted to the state commissions for approval. Section 252(a)(1) states:

> Upon receiving a request for interconnection, services, or network elements pursuant to section 251 of this title, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251 of this title. The agreement shall include a detailed schedule of itemized charges for interconnection and each service or network element included in the agreement. The agreement, including any interconnection agreement negotiated before February 8, 1996, shall be submitted to the State commission under subsection (e) of this section.

The FCC promulgated 47 C.F.R. § 51.303 which requires all interconnection[9] agreements, even those that predate the 1996 Act, to be submitted to the state commissions for approval. The rule states, "All interconnection agreements between an incumbent LEC and a telecommunications carrier, including those negotiated before February 8, 1996, shall be submitted by the parties to the appropriate state commission for approval...." 47 C.F.R. § 51.303(a).

The petitioners argue that the rule violates the explicit language of the Act because, while the Act references agreements entered into pursuant to § 251, the rule applies to *all* agreements, even those entered into years before the Act was passed. The petitioners explain that agreements negotiated and entered into pre-1996 could not have been entered into "pursuant to section 251" because § 251 did not exist at that time, and therefore, only agreements that were either negotiated before the Act and formally entered into after the Act, or agreements that were both negotiated and formally entered into after the Act, must be submitted for approval.

The respondents contend that the agreement referred to in the third sentence of § 252(a)(1) is not limited to the agreement mentioned in the first and second sentences. The first and second sentences, they argue, refer to agreements reached pursuant to § 251, while the agreement mentioned in

---

[9] We note that the term "interconnection" has been defined by the FCC as "the physical linking of two networks for the mutual exchange of traffic." First Report and Order ¶ 26.

the third sentence refers to all, including pre-Act, agreements. The respondents explain that the term "negotiated" in the phrase set off by commas in the third sentence means a completed negotiation or, in other words, a negotiation that has resulted in a completed interconnection agreement.

We agree with the petitioners that the rule is contrary to the language of the Act. The respondents attempt to isolate the third sentence of § 252(a)(1) from the prior two sentences. The FCC concluded "that the final sentence of section 252(a)(1), which requires that any interconnection agreement must be submitted to the state commissions, can and should be read to be independent of the prior sentences in section 252(a)(1)." First Report and Order ¶ 166. This is not a proper construction because "we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." *United States Nat'l Bank of Oregon v. Independent Ins. Agents*, 508 U.S. 439, 455, 113 S.Ct. 2173, 124 L.Ed.2d 402 (1993).

The subsection in question begins by making reference to a competitor's "request ... pursuant to section 251." Upon receiving such a request, the competitor and the ILEC "may negotiate and enter into a binding agreement" without regard for the interconnection and unbundled network element access standards of § 251(b) and (c). The second sentence requires that the agreement so negotiated and entered into contain a detailed schedule of itemized charges for the items covered by the "agreement." The third sentence begins with the words, "[t]he agreement" (which can only mean the same agreement authorized by the first sentence and referred to in the second sentence) and requires that it be submitted to the state commission for approval pursuant to subsection (e).

The phrase in the third sentence set off by commas, which reads, "including any interconnection agreement negotiated before February 8, 1996," serves as the co-subject of the verb form "shall be submitted" and explains and defines what else besides the "agreement" mentioned in the first two sentences of the section must be submitted to the state commission. The "what else" that must be submitted to the state commission for approval is any interconnection agreement "negotiated" before February 8, 1996.

Congress was aware that many states were already exploring and experimenting with ways to open up local telephone markets to competition, and that telephone carriers were involved with each other in negotiations for those purposes prior to and at the time of the Act's passage. *See, e.g.*, S.REP. NO. 104-23, at 5 (1995). By using the phrase "including any interconnection agreement negotiated before February 8, 1996," Congress brought within the sphere of required state commission approval all interconnection agreements entered into after February 8, 1996, including specifically those whose terms were arrived at by negotiation prior to that date but which had not yet been formally entered into by the parties. Because that unique group of interconnection agreements (those that were negotiated before but not yet entered into by February 8, 1996) could not have been agreements prompted or originated by either a request made under the Act or by the duty to negotiate contained in the Act (as the Act was not yet in existence at the time they were being negotiated), they could not be an "agreement" covered by the first two sentences and the first two words of the third sentence of § 252(a)(1). Nevertheless, because their subject matter, interconnection, was one which the Act was intended to compel, and because they would be entered into

after the effective date of the Act, it was logical for Congress to want them subject to the Act's provisions. The use of the statutory language "including any interconnection agreement negotiated before February 8, 1996" also eliminated any argument that the agreeing carriers could have made in order to avoid state commission approval that their agreement had been negotiated before the Act's date and, therefore, was not subject to it.

We also think it of some significance that Congress intentionally used both the terms "negotiate" and "enter into" in the first sentence of § 252(a)(1) but only used the verb "negotiated" in the third sentence. Had Congress wanted to include all interconnection agreements that had been both negotiated and entered into before the Act's effective date within the scope of the third sentence, all it had to do was use the same words it had used in the first sentence. *See Kifer v. Liberty Mut. Ins. Co.*, 777 F.2d 1325, 1333 n. 9 (8th Cir. 1985) (" 'When the same word or phrase is used in the same section of an act more than once, and the meaning is clear as used in one place, it will be construed to have the same meaning in the next place.' ") (quoting *United States v. Nunez*, 573 F.2d 769, 771 (2d Cir.), *cert. denied*, 436 U.S. 930, 98 S.Ct. 2828, 56 L.Ed.2d 774 (1978)). It did not, and its choice not to do so reinforces our conclusion that Congress did not intend to do so. *See, e.g., Johnson v. United States*, 120 S.Ct. 1795, 1803, 146 L.Ed.2d 727 (2000) (When Congress means the same consequences, it is "natural for Congress to write in like terms.").

Across the country there were thousands of interconnection agreements existing between and among ILECs before the Act was passed. In Wisconsin alone the

state commission estimated that there were over 3,000 pre-Act agreements which, under the FCC's construction of § 252, would now have to be submitted for approval. *See* Addendum to Br. of Pet'rs United States Telephone Ass'n et al. at 9. Many of those agreements were between neighboring noncompeting ILECs for the exchange of features and functions. There is no indication that Congress intended the state commissions to go back through years of agreements and approve or disapprove them. We conclude that Congress knew it was already giving the state commissions a huge amount of new work to do in arbitrating and approving the new agreements that would quickly be coming into being by virtue of the substantive provisions of the Act, and that it did not intend to add an even heavier burden by forcing the state commissions to replow old ground. The FCC's construction of the statute is unreasonable.

We further find it difficult to square the FCC's interpretation with the recognized presumption against retroactive legislation. By construing the word "negotiated" in the third sentence to mean "negotiated and entered into," the FCC's rule reaches back and requires something that the parties to the preexisting agreement had no reason to expect--required state commission approval under new and different standards which affect the rights the parties had at the time they entered into their agreement. *See Landgraf v. USI Film Prods.*, 511 U.S. 244, 280 (1994). Here again Congress's choice not to use the words "entered into" in the third sentence tells us that Congress did not intend the retroactive effect the FCC has given to the Act. Absent clear Congressional intent for retroactive effect, there should be none. *See id.* By making the Act applicable to interconnection agreements that were only negotiated before

the Act's effective date (but not yet entered into), Congress gave the parties the option of either proceeding to enter into the negotiated agreement with the knowledge it would have to be submitted to the state commission for approval, or not. In so doing, an unwanted retroactive effect can be avoided, the parties can proceed knowing what the law will be, and the effect of the Act is entirely prospective.

We hold that § 252(a)(1) applies to any agreement which was either (1) both negotiated and entered into pursuant to § 251 after the Act went into effect or (2) is an interconnection agreement that was negotiated before, but not yet entered into when, the Act went into effect.

Consequently, we vacate rule 51.303.

III. Conclusion

We grant the pending petitions for review in part. For the reasons stated, we vacate, in total, 47 C.F.R. §§ 51.505(b)(1), 51.609, 51.513, 51.611, 51.707, 51.317, 51.405(a), (c), and (d), and 51.303. We remain firm in our previous decision to vacate 47 C.F.R. §§ 51.305(a)(4) and 51.311(c) (the superior quality rules) and 47 C.F.R. § 51.315(c)- (f) (the additional combinations rule). In all other respects, we deny the petitions for review.

APPENDIX B

FROM *IN RE IMPLEMENTATION OF THE LOCAL COMPETITION PROVISIONS IN THE TELECOMMUNICATIONS ACT OF 1996*, FIRST REPORT AND ORDER, CC DOCKET NO. 96-98 (AUG. 8, 1996):

¶¶ 618 - 740

VII. PRICING OF INTERCONNECTION AND UNBUNDLED ELEMENTS

A. Overview

618. The prices of interconnection and unbundled elements, along with prices of resale and transport and termination, are critical terms and conditions of any interconnection agreement. If carriers can agree on such prices voluntarily without government intervention, these agreements will be submitted directly to the states for approval under section 252. To the extent that the carriers, in voluntary negotiations, cannot determine the prices, state commissions will have to set those prices. The price levels set by state commissions will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* and favors one party (whether favoring incumbents or entrants) or, as we believe Congress intended, *pro-competition*. As discussed more fully in Section II.D. above, it is therefore critical to implementing Congress's pro-competitive, de-regulatory national policy framework to establish among the states a common, pro-competition understanding of the pricing standards for interconnection and unbundled elements, resale,

and transport and termination. While such a common interpretation might eventually emerge through judicial review of state arbitration decisions, we believe that such a process could delay competition for years and require carriers to incur substantial legal costs.[1490] We therefore conclude that, to expedite the development of fair and efficient competition, we must set forth rules now establishing this common, pro-competition understanding of the 1996 Act's pricing standards. Accordingly, the rules we adopt today set forth the methodological principles for states to use in setting prices. This section addresses interconnection and unbundled elements, and subsequent sections address resale and transport and termination, respectively.

619. While every state should, to the maximum extent feasible, immediately apply the pricing methodology for interconnection and unbundled elements that we set forth below, we recognize that not every state will have the resources to implement this pricing methodology immediately in the arbitrations that will need to be decided this fall. Therefore, so that competition is not impaired in the interim, we establish default proxies that a state commission shall use to resolve arbitrations in the period before it applies the pricing methodology. In most cases, these default proxies for unbundled elements and interconnection are ceilings, and states may select lower prices. In one instance, the default proxy we establish is a price range. Once a state sets prices according to an economic cost study conducted pursuant to the cost-based pricing methodology we outline, the defaults cease to apply. In setting a rate pursuant to the cost-based

---

[1490] For a discussion of our legal authority to adopt national pricing rules, *see supra*, Section II.D.

pricing methodology, and especially when setting a rate above a default proxy ceiling or outside the default proxy range, the state must give full and fair effect to the economic costing methodology we set forth in this Order and must create a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate.

620. In the following sections, we first set forth generally, based on the current record, a cost-based pricing methodology based on forward-looking economic costs, which we conclude is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market- determined prices and forward-looking economic costs. If market prices exceed forward-looking economic costs, new competitors will enter the market. If their forward-looking economic costs exceed market prices, new competitors will not enter the market and existing competitors may decide to leave. Prices for unbundled elements under section 251 must be based on cost under the law, and that should be read as requiring that prices be based on forward-looking economic costs. New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants' investment decisions would be distorted if the price of unbundled elements were based on embedded costs. In arbitrations of interconnection arrangements, or in rulemakings the results of which will be applied in arbitrations, states must set prices for interconnection and unbundled network elements based on the

forward-looking, long-run, incremental cost methodology we describe below. Using this methodology, states may not set prices lower than the forward- looking incremental costs directly attributable to provision of a given element. They may set prices to permit recovery of a reasonable share of forward-looking joint and common costs of network elements.[1491] In the aftermath of the arbitrations and relying on the state experience, we will continue to review this costing methodology, and issue additional guidance as necessary.

621. We reject various arguments raised by parties regarding the recovery of costs other than forward-looking economic costs in section 251(c)(2) and (c)(3) prices, including the possible recovery of: (1) embedded or accounting costs in excess of economic costs; (2) incumbent LECs' opportunity costs; (3) universal service subsidies; and (4) access charges. As discussed in Section VII.B.2.a. below, certain portions of access charges may continue to be collected for an interim period in addition to section 251(c)(3) prices.

622. With respect to prices developed under the forward-looking, cost-based pricing methodology, we conclude that incumbent LECs' rates for interconnection and unbundled elements must recover costs in a manner that reflects the way they are incurred. We adopt certain rules that states must follow in setting rates in arbitrations. These

---

[1491] We define these and other forward-looking cost concepts *infra*, Section VII.B.2.a. We define what we consider to be a reasonable share of forward- looking joint and common costs *infra*, Section VII.B.2.a.

rules are designed to ensure the efficient cost- based rates required by the 1996 Act.

623. In the next section of the Order, we establish default proxies that states may elect to use prior to utilizing an economic study and developing prices using the cost-based pricing methodology. We recognize that certain states may find it difficult to apply an economic costing methodology within the statutory time frame for arbitrating interconnection disputes. We therefore set forth default proxies that will be relatively easy to apply on an interim basis to interconnection arrangements. We discuss with respect to particular unbundled elements the reasonable rate structure for those elements and the particular default proxies we are establishing for use pending our adoption of a generic forward-looking cost model. Finally, we discuss the following additional matters: generic forward-looking costing models that we intend to examine further by the first quarter of 1997 in order to determine whether any of those models, with modifications, could serve as better default proxies; the future adjustment of rates; the relationship of unbundled element prices to retail prices; and the meaning of the statutory prohibition against discrimination in sections 251 and 252.

624. Those states that have already established methodologies for setting interconnection and unbundled rates must review those methodologies against the rules we are adopting in this Order. To the extent a state's methodology is consistent with the approach we set forth herein, the state may apply that methodology in any section 252 arbitration. However, if a state's methodology is not consistent with the rules we adopt today, the state must modify its approach. We invite any state uncertain about

whether its approach complies with this Order to seek a declaratory ruling from the Commission.

B. Cost-Based Pricing Methodology

625. As discussed more fully in Section II.D. above, although the states have the crucial role of setting specific rates in arbitrations, the Commission must establish a set of national pricing principles in order to implement Congress's national policy framework. For the reasons set forth in the preceding section and as more fully explained below, we are adopting a cost-based methodology for states to follow in setting interconnection and unbundled element rates. In setting forth the cost-based pricing methodology for interconnection and access to unbundled elements, there are three basic sets of questions that must be addressed. First, does the 1996 Act require that the same standard apply to the pricing of interconnection provided pursuant to section 251(c)(2), and unbundled elements provided pursuant to section 251(c)(3)? Second, what is the appropriate methodology for establishing the price levels for interconnection and for each unbundled element, how should costs be defined, and is the price based on economic costs, embedded costs, or other costs? Third, what are the appropriate rate structures to be used to set prices designed to recover costs, including a reasonable profit? We address each of these questions in the following sections.

1. Application of the Statutory Pricing Standard

a. Background

626. In the NPRM, we proposed that any pricing principles we adopt should be the same for interconnection and unbundled network elements because sections 251(c)(2) and (c)(3) and 252(d)(1) use the same pricing standard.[1492] We invited parties to comment on this issue and to justify any proposed distinction in the priority for interconnection and unbundled network elements. We also stated our belief that the same pricing rules that apply to interconnection and unbundled network elements should also apply to collocation under section 251(c)(6) of the 1996 Act.

b. Comments

627. Commenters generally agree that any pricing rules adopted by the Commission for interconnection and unbundled elements should be the same.[1493] These parties assert that any pricing rules the Commission ultimately adopts should not, therefore, create incentives to substitute or arbitrage one type of classification for another. Commenters also generally agree that the pricing rules the Commission adopts for interconnection and unbundled elements should also apply to collocation.[1494] Many of these parties agree that collocation is a subset of the interconnection arrangements

---

[1492] NPRM at para. 122.

[1493] *See, e.g.*, Citizens Utilities comments at 16 n.14; Ohio Commission comments at 42; Teleport comments at 46.

[1494] *E.g.*, ACSI comments at 16; ALTS comments at 34-35; Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MCI comments at 54, 61; MFS comments at 30; NEXTLINK comments at 26; PacTel comments at 63; Sprint comments at 42; Teleport comments at 46.

contemplated by sections 251(c)(2) and 252(d)(1).[1495] On the other hand, a few parties contend that the pricing standards contained in section 252(d)(1) for interconnection and unbundled elements do not apply to collocation provided under section 251(c)(6).[1496] BellSouth argues that the Commission should not adopt any national standards for virtual collocation.[1497] Other commenters, including some that oppose the establishment of pricing rules by the Commission, argue that, to the extent that the Commission adopts national standards for collocation, they should generally follow those established in the Commission's *Expanded Interconnection* proceeding in CC Docket No. 91-141.[1498]

c. Discussion

628. Sections 251(c)(2) and (c)(3) impose an identical duty on incumbent LECs to provide interconnection and access to network elements "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[1499] In addition, both interconnection and unbundled network elements are made subject to the same

---

[1495] *See, e.g.*, Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MFS comments at 30; NEXTLINK comments at 26.

[1496] *See, e.g.*, SNET comments at 24 n

[1497] BellSouth comments at 23.

[1498] *See, e.g.*, Bell Atlantic comments at 32-34.

[1499] 47 U.S.C. § 251(c)(2), (c)(3).

pricing standard in section 252(d)(1). Based on the plain language of sections 251(c)(2), (c)(3), and section 252(d)(1), we conclude that Congress intended to apply the same pricing rules to interconnection and unbundled network elements. The pricing rules we adopt shall, therefore, apply to both.

629 We further conclude that, because section 251(c)(6) requires that incumbent LECs provide physical collocation on "rates, terms, and conditions that are just, reasonable, and nondiscriminatory," which is identical to the standard for interconnection and unbundled elements in sections 251(c)(2) and (c)(3), collocation should be subject to the same pricing rules.[1500] We also note that, because collocation is a method of obtaining interconnection and access to unbundled network elements, collocation is properly treated under the same pricing rules. This legal conclusion that there should be a single set of pricing rules for interconnection, unbundled network elements, and collocation provides greater consistency and guidance to the industry, regulators, and the courts. Moreover, it reduces the regulatory burdens on state commissions of developing and applying different pricing rules for collocation, interconnection, and unbundled network elements. We note that our adoption of this single set of pricing rules should minimize regulatory burdens, conflicts, and uncertainties associated with multiple, and possibly inconsistent rules, thus facilitating competition on a reasonable and efficient basis minimizing the economic impact of our rules for all parties, including small entities and small incumbent LECs.[1501]

[1500] *See supra*, Section VI.B.

[1501] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

2. Rate Levels

a. Pricing Based on Economic Cost

(1) Background

630. We observed in the NPRM that economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.[1502] We noted, however, that there was a lack of general agreement on the specifics of methodology for deriving prices based on LRIC or total service long-run incremental cost (TSLRIC). We invited parties to comment on whether we should require the states to employ a LRIC-based pricing methodology and to explain with specificity the costing methodology they support.[1503] We recognized, however, that prices based on LRIC might not permit recovery of forward-looking costs if there were significant forward-looking joint and common costs among network elements.[1504] We sought comment on how, if rates are set above incremental cost, to deal with the problems inherent in allocating common costs and any other overheads.[1505] We observed that, by defining the unbundled elements at a sufficiently aggregated level, it may be possible

---

[1502] NPRM at para. 124.

[1503] *Id.* at para. 126.

[1504] *Id.* at para. 129.

[1505] *Id.* at para. 130.

to reduce the costs to be allocated as joint and common by identifying a substantial portion of costs as incremental to a particular element. To the extent that joint and common costs cannot be entirely eliminated, we sought comment on various methodologies for assigning them, including the use of a fixed allocator or on the basis of inverse demand elasticity. We also sought comment on whether, regardless of the method of allocating common costs, we should limit rates to levels that do not exceed stand-alone costs.[1506] Finally, we invited parties to comment on whether a LRIC-based methodology would establish a price for interconnection and unbundled network elements that includes a reasonable profit and thus complies with section 252(d)(1).[1507]

631. A number of states already employ, or have plans to utilize, some form of LRIC or TSLRIC methodology in their approach to setting prices for unbundled network elements,[1508] with several states choosing LRIC or TSLRIC

[1506] *Id.* For a definition of stand-alone costs, *see* Section VII.B.2.a. *infra*.

[1507] 47 U.S.C. § 252(d)(1)(A)(i); NPRM at para. 129.

[1508] *See, e.g.*, California Commission comments at 29 (California has adopted TSLRIC as the standard for developing the costs of unbundled elements and in a rulemaking this summer will determine the unbundled network elements and what level of shared and common costs should be included in the price of each); Michigan Commission comments at 13 (1996 prices for loops to remain at levels established by the Michigan Commission in its original interconnection order or at TSLRIC); Texas Commission comments at 22 (Texas Commission has employed LRIC-based pricing methodologies for many years; SWBT and GTE required to file LRIC cost studies to be used in pricing not later than November 1, 1996).

as a price floor.[1509] For instance, the Connecticut Commission adopted a TSLRIC methodology to measure the cost of service of SNET, its principal incumbent LEC.[1510] Arizona also requires incumbent LECs to conduct TSLRIC cost studies to establish the underlying cost of unbundled services and facilities.[1511] The Ohio Commission has adopted Long Run Service Incremental Cost ("LRSIC"), which is closely related to TSLRIC.[1512] The Missouri and Wyoming Commissions are among a number of state commissions that have not yet adopted a pricing methodology, but are considering LRIC or TSLRIC.[1513] Oklahoma law provides for

---

[1509] *See, e.g.*, Colorado Commission comments at Attachment (Rules Prescribing Principles for Costing and Pricing of Regulated Services of Telecommunications Service Providers) 4 CCR 723-30, Rules 4-5; Hawaii Administrative Rules, Sections 6-80-32-34 (setting out a three-tiered pricing regime with TSLRIC set as floor for pricing of competitive services); Louisiana Commission comments at Attachment (Louisiana Public Service Commission "Regulations for Competition in the Local Telecommunications Market"), p.30; Washington Commission comments at 25, Appendix B (*Washington Utilities and Transportation Commission v. US West Communications*, Docket No. UT-950200 at 82 (Washington Commission, April 11, 1996)); Wisconsin Stat. Ann. section 196.204 (requiring the price of each network service or function to exceed TSLRIC).

[1510] Connecticut Commission comments at 4.

[1511] Arizona Commission comments, Exhibit V (Arizona Administrative Code R14-2-1101 *et seq.*), p. 10.

[1512] *See* Ohio Commission comments at 43-45.

[1513] *See, e.g.*, Missouri Commission comments at 11 (supports LRIC for costing; LRIC is defined in pending state legislation); Wyoming Commission comments at 26-27 (draft rules propose use of TSLRIC as a

submission of LRIC cost studies and studies identifying a contribution to common costs for interconnection of facilities and access to network elements to the Oklahoma Commission during an arbitration.[1514] A number of states have yet to choose a pricing methodology. For instance, the New York Commission sets prices on a case-by- case basis.[1515] Unbundled element prices also exist in several states pursuant to negotiated interconnection agreements that have either already been approved by state commissions or are under consideration.[1516]

---

price floor, with prices to include a contribution to shared, common, and joint costs, and the sum of prices for unbundled elements not to exceed retail for bundled services; incumbent LECs shall impute the prices of unbundled elements into the price floors of each of their own services that utilize the network elements).

[1514] Oklahoma Commission comments at Appendix A (Corporation Commission Telephone Rules OAC 165:55-17-25), pp. 10-11.

[1515] *Competition, The State Experience* at 80 (compilation of written responses by state commission staffs to questions by FCC staff, compiled by NARUC) (March 8, 1996).

[1516] According to information in our possession, such agreements have been negotiated in, among other states, Alabama, Florida, Georgia, Kentucky, Illinois, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee. Letter from W.W. Jordan, Executive Director -- Federal Regulatory, BellSouth, to William F. Caton, Acting Secretary, July 11, 1996 at Attachment (containing chart detailing agreements between BellSouth and new entrants in Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee); "Interconnection Agreement Under Sections 251 and 252 of the telecommunications Act of 1996, by and between, Ameritech Information Industry Services and MFS Intelenet of Illinois, Inc.," dated May 17, 1996 filed July 25, 1996).

632. Section 252(d)(1) requires, *inter alia*, that rates for interconnection and unbundled network elements be based on "cost (determined without reference to a rate-of-return or other rate-based proceeding)."[1517] We tentatively concluded in the NPRM that this language precludes states from setting rates by use of traditional cost-of service regulation, with its detailed examination of historical carrier investment and expenses.[1518] Instead, we indicated our belief that the statute contemplates the use of other forms of cost-based price regulation, such as the setting of prices based on forward-looking economic cost methodologies (such as LRIC) that do not involve the use of an embedded rate base. We sought comment on whether section 252(d)(1) forecloses consideration of historical or embedded costs or merely prohibits state commissions from conducting a traditional rate-of-return proceeding to establish prices for interconnection and unbundled network elements. Embedded costs are the costs that the incumbent LECs carry on their accounting books that reflect historical purchase prices, regulatory depreciation rates, system configurations, and operating procedures. We invited parties to comment on whether incumbent LECs should be permitted to recover some portion of their historical or embedded costs over TSLRIC.[1519]

633. In the NPRM, we noted that certain incumbent LECs had advocated that interconnection and access to

---

[1517] 47 U.S.C. § 252(d)(1)(B).

[1518] NPRM at para. 123.

[1519] *Id.* at para. 129.

unbundled element prices be based on the "efficient component pricing rule" (ECPR).[1520] Under this approach, an incumbent LEC that sells an essential input element, such as interconnection, to a competing network would set the price of that input element equal to "the input'sdirect per-unit incremental costs plus the opportunity cost to the input supplier of the sale of a unit of input."[1521] We tentatively concluded in the NPRM that ECPR or equivalent methodologies are inconsistent with the section 252(d)(1) requirement that rates be based on "cost," and we proposed to preclude the states from using this methodology.[1522]

634. Section 254 requires the Commission and the Joint Board established thereunder to ensure that "[a]ll providers of telecommunications service ... make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service ... ." That section further provides that "[t]here should be specific, predictable, and sufficient Federal and State mechanisms to preserve and advance universal service."[1523] The Conference Committee also explained that these provisions require any such

---

[1520] *Id.* at para. 147. *See* William J. Baumol, *Some Subtle Issues in Railroad Deregulation*, 10 Int'l J. Trans. Econ. 341 (1983); William Baumol & Gregory Sidak, *Toward Competition in Local Telephony* (1994); William Baumol & Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171 (1994).

[1521] William Baumol & Gregory Sidak, *The Price of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171, 178.

[1522] NPRM at para. 148.

[1523] 47 U.S.C. § 254(b)(4) and (b)(5).

universal service support payment to be, to the extent possible, "explicit, rather than implicit as many support mechanisms are today."[1524] In the NPRM, we sought comment on whether "it would be consistent with sections 251(d)(1) and 254 for states to include any universal service costs or subsidies in the rates they set for interconnection, collocation, and unbundled network elements."[1525] In particular, we discussed the "play or pay" system adopted by the state of New York in which interconnectors that agree to serve all customers in their self- defined service areas ("players") potentially pay a substantially lower interconnection rate than those that serve only selected customers ("payers") and are, therefore, liable to pay additional contribution charges.[1526] We noted that the statutory schedule for the completion of the universal service reform proceeding (15 months from the enactment of the 1996 Act) is different from that for this proceeding (6 months from the date of enactment of the 1996 Act). We asked whether the ability of states to take universal service support into account differs pending completion of the section 254 Joint Board proceeding or state universal service proceedings, pursuant to section 254(f), during any transition period that

---

[1524] Joint Explanatory Statement at 130-31. "In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit." *Id.* at 131; *See also* 47 U.S.C. § 254(e).

[1525] NPRM at para. 145.

[1526] *Id.*

may be established in the section 254 proceeding or thereafter.[1527]

(2) Comments

635. *Forward-Looking Costs.* Most new entrants and IXCs agree that prices for interconnection and unbundled elements should be based on forward-looking, economic costs.[1528] Many state commissions also argue that, if federal pricing rules are adopted, forward-looking methodologies should serve as the basis for establishing rates in a competitive environment.[1529] The Department of Justice contends that pricing above forward-looking economic costs would subject competitors to substantial risk of a price squeeze because the real cost of a network element for the incumbent LEC will be its forward- looking economic cost, while the cost to the new entrant will be the higher price

---

[1527] *Id.*

[1528] *See, e.g.*, ACSI comments at 54-55; AT&T comments at 47; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 59, 61; NEXTLINK comments at 27; Sprint comments at 43-44; Teleport comments at 46; Telecommunications Resellers Ass'n comments 38-39; *See also* Ad Hoc Telecommunications Users Committee comments at 31-34; DoJ comments at 27-32; Frontier comments at 21-22; Texas Public Utility Counsel comments at 33-34; Attorneys General reply at 3; NCTA reply at 18-20; NTIA reply at 17-18 n.35.

[1529] *See, e.g.*, New York Commission comments at 3-4; Missouri Commission comments at 11; Kentucky Commission comments at 4-5; Wyoming Commission comments at 27-28; Ohio Commission comments at 41-43.

charged for the element by the LEC.[1530] Parties favoring a forward- looking, incremental cost methodology argue that it is the appropriate pricing standard for several reasons. First, such an approach simulates the prices for network elements that would result if there were a competitive market for the provision of such elements to other carriers.[1531] In such a market, these parties argue, competition would drive prices to forward-looking costs, even if such costs were lower than a firm's historical costs.[1532] Second, unbundled element prices based on forward-looking economic costs prevent incumbent LECs from exploiting their market power at the expense of their competitors that are dependent on the incumbent LEC's facilities.[1533] Third, a forward-looking incremental cost methodology creates the right investment incentives for competitive facilities-based entry and creates incentives for the market to move towards competition while preserving opportunities for competition even if some network elements prove to be resistant to competition.[1534] Fourth, a pricing methodology based on forward-looking economic costs

---

[1530] DoJ comments at 28-31.

[1531] *See, e.g.*, DoJ comments at 28-29.

[1532] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.5; DoJ comments at 28-29.

[1533] *See, e.g.*, DoJ comments at 30.

[1534] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.7; DoJ comments at 29; NCTA comments at Appendix B (Unbundling, Interconnection, and Traffic Exchange: The Pricing of Access to Local Exchange Networks), p. 22.

minimizes the incumbent LECs' opportunities to engage in anticompetitive cross-subsidization that could delay the emergence of effective competition.[1535] Finally, these parties argue that pricing based on forward-looking economic costs will lead to lower prices for consumers.[1536]

636. While many commenters agree that the proper economic cost standard for interconnection and unbundled elements is one based on forward-looking LRIC, the record indicates a lack of consensus on the precise definition of such a methodology. While many parties, including some incumbent LECs, favor a pricing methodology based on TSLRIC,[1537] others contend that LRIC provides the appropriate basis for pricing interconnection and unbundled

---

[1535] *See, e.g.*, DoJ comments at 30-31.

[1536] *See, e.g.*, DoJ comments at 28-31.

[1537] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 34-36; AT&T comments at 47-48; ALTS comments at 35-36; Ameritech comments at 63-64 (but must include recovery of joint, common, and residual costs); CFA/CU comments at 26-32 (including a contribution to joint and common costs); Citizens Utilities comments at 18; Comcast comments at 23; CompTel comments at 67-71; Competition Policy Institute comments at 8; DoJ comments at 28-31 (including any joint and common costs); Frontier comments at 21-22; Intermedia comments at 14; LDDS comments at 56, 62; MCI comments at 60-61; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24-25 (including a markup over TSLRIC to reflect a reasonable allocation of joint and common costs); SNET reply at 5-7 (including a reasonable contribution to common costs); Sprint comments at 44 (plus a reasonable contribution to joint and common costs), reply at 28-32; TCC comments at 14.

elements.[1538] AT&T argues that, because incumbent LECs will be providing access to unbundled network elements and interconnection, and not merely the individual services that use those elements, the relevant question is the incumbent LEC's cost of producing the entire demand for network elements.[1539] Because TSLRIC defines a cost increment relative to a hypothetical situation in which the supplier does not currently provide the network element at all and thus must construct and operate all element-specific facilities necessary to produce the network element, AT&T believes that TSLRIC, unlike LRIC, includes all element-specific fixed costs.[1540]

637. The Consumer Federation of America argues that costs must be analyzed consistently across all major services using the same cost methodology, *i.e.*, individual functionalities or specific capacities must have similar costs across services.[1541] AT&T argues that TSLRIC should exclude all costs attributable to the incumbent LECs' retailing operations, and that all other cost allocations should be competitively-neutral and assigned on an equally proportional basis relative to attributable costs.[1542] ALTS argues that the

---

[1538] *See, e.g.*, Texas Statewide Tel. Cooperative comments at 8-11, 14.

[1539] AT&T comments at 47, Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.6.

[1540] *Id.* at 48.

[1541] CFA/CU comments at 32.

[1542] AT&T comments at 61-62, 64-65.

underlying data from a TSLRIC study should be accessible for purposes of replicating the study methods and comparisons to other public data.[1543] NTIA contends that the Commission should require the states to consider recovery of only those costs that the incumbent can convincingly demonstrate are incurred in service provisioning.[1544] Supporters of a forward-looking economic cost methodology argue that TSLRIC studies can be prepared quickly to establish interconnection and unbundled element prices.[1545]

638. Incumbent LECs generally oppose the adoption of a forward-looking, long- run incremental costing methodology.[1546] At least five major reasons are offered in opposition. First, opponents of a forward-looking, long-run incremental costing methodology argue that setting the price of each discrete service based on LRIC will not recover the total costs of the network because if prices are set equal to the cost of the last unit, total revenues will fall short of total costs.[1547] Second, PacTel argues that a forward-looking cost methodology also suffers from the "fallacy of perfect competition" because it does not account for the fact that,

---

[1543] ALTS comments at 36-37.

[1544] NTIA reply at 28.

[1545] *See, e.g.*, LDDS comments at 64-65.

[1546] *See, e.g.*, Matanuska comments at 3-4; NYNEX comments at 46-47; PacTel comments at 66-67; TCA comments at 8.

[1547] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp.3-4; NECA comments at 8; Rural Tel. Coalition comments at 25.

while it is true that competition drives the price of every product toward incremental cost, every multi-product firm must have some products priced far enough above incremental cost to recover its total costs and return a profit to investors.[1548] Third, incumbent LECs argue that setting prices based on the forward-looking economic cost of the element will not create incentives for new entrants to build their own facilities,[1549] and will discourage efficient entry and useful investment by both incumbent LECs and their competitors.[1550] Fourth, some opponents of a forward-looking, economic cost methodology contend that such an approach raises significant practical and administrative problems because LRIC studies are expensive to conduct, almost impossible to audit or review particularly for small entities seeking to enter the local exchange market, highly subjective, and the necessary data are under the exclusive control of the party subject to the agreement.[1551] USTA and other commenters also argue that use of LRIC cost studies would fail to capture differences in geographic regions, thereby denying small incumbent LECs a

---

[1548] PacTel comments at 68-69; *see also* Rural Tel. Coalition reply at 26-27.

[1549] *See, e.g.*, Bell Atlantic comments at 38; SBC comments at 91-92.

[1550] *See, e.g.*, PacTel comments at 70; SBC comments at 90-92; *see also* U S West comments at Exhibit A (Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange), p.9.

[1551] *See, e.g.*, Bell Atlantic comments at Attachment 2 (Declaration of Robert W. Crandall), p.8; MFS comments at 54, reply at 11-12; NECA comments at 8.

reasonable opportunity to recover their costs.[1552] Finally, many opponents of a forward-looking, economic cost approach to pricing interconnection and access to unbundled elements argue also that such a methodology precludes any contribution to joint and common costs and does not allow the recovery of historical costs.[1553] These parties contend that network providers must be permitted to recover their total costs of service, including a return on investment and a reasonable allocation of joint, common, and historical costs.[1554]

639. Incumbent LECs generally contend that costs should be based on the individual incumbent LEC's existing network design and technology instead of the idealized least-cost, most efficient network design and technology.[1555]

[1552] *E.g.*, USTA comments at 45-50; Bay Springs reply at 8.

[1553] *See, e.g.*, BellSouth comments at 56-57; NYNEX comments at 50-52; PacTel comments at 65-66; SBC comments at 88, reply at 24-25; U S West reply at 9, 12 (stating that depreciation expenses should be properly allocated); *see also* NECA comments at 8; TCA comments at 8-9. For a discussion of recovery of joint, common, and embedded costs, *see infra* Section VII.B.2.a.

[1554] *See, e.g.*, Ameritech comments at 60, reply at 30-33 (stating that residual cost recovery must also be permitted); Bell Atlantic comments at 35- 36 (stating that the recovery of the total costs of constructing and operating the networks must also be permitted); NYNEX comments at 42-44; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp

[1555] *See, e.g.*, Ameritech reply at 32-33; Bell Atlantic reply at 17-18; Bellsouth reply at 36-37; *see also* GVNW comments at 36; USTA comments at 40, reply at 21-22.

USTA argues that, if competitors want to use an incumbent LEC's embedded plant, competitors should pay for the existing plant, not some theoretical, more efficient plant.[1556] In addition, these parties argue that, if a new entrant can purchase the unbundled element from the incumbent LEC at a price no higher than the cost of the least-cost, most efficient provider, then the new entrant has little incentive to invest in its own facilities. Ameritech also contends that section 252(d)(1) addresses recovery of the incumbent LEC's costs of providing interconnection and unbundled network elements, not the costs of a hypothetical carrier.[1557]

640. On the other hand, several new entrants argue that a forward-looking economic cost methodology should be based on an efficient provider's costs of producing a service.[1558] These parties contend that, in a competitive market, prices are determined by the cost of efficient potential

---

[1556] USTA comments at 40.

[1557] Ameritech reply at 32.

[1558] *See, e.g.*, ACSI comments at 56; AT&T comments at 57-60 (optimally configured and sized assets with current technology and efficient operating practices); AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p. 10 (efficient, cost-minimizing competitor); GST comments at 26-27 (costs of an efficient LEC rather than the actual costs of an incumbent LEC); Teleport reply at 30 (best available technology at today's prices); *see also* DoJ reply at 9-11 (best generally available technology); Louisiana Commission comments at 4, 15; Telecommunications Resellers Ass'n comments at 38 (most efficient available technology).

entrants, not the embedded costs of existing firms.[1559] In addition, a pricing standard based on the costs of the element using the most-efficient technology prevents incumbent LECs from charging competitors for the cost of facilities that would in fact be used in large part by the incumbent LECs themselves to compete in new markets such as interexchange service.[1560] Sprint, however, argues that prices should be based on the incumbent LEC's average utilization and existing network design and technology, not on an idealized network and technology that may bear no relationship to the incumbent LECs existing operations.[1561]

641. USTA, Bell Atlantic, and BellSouth have asserted in various filings and *ex parte* presentations that TSLRIC-based pricing would not properly compensate incumbent LECs for certain factors that affect capital costs and economic depreciation rates.[1562] First, when technological progress lowers equipment costs, the replacement or forward-looking economic cost of certain durable sunk investments can be expected to decline over time. In this case the correct measure of cost over any period

---

[1559] *See, e.g.*, TCC comments at 17.

[1560] DoJ reply at 10.

[1561] Sprint reply at 31-32.

[1562] USTA reply comments at Attachment 1 (Reply Affidavit of Jerry A. Hausman); Bell Atlantic comments at Attachment 1(Affidavit of Jerry A. Hausman); Letter from Robert T. Blau, Vice President, Executive and Federal Regulatory Affairs, BellSouth, to William F. Caton, Acting Secretary, FCC, July 25, 1996, at Attachment (Response to Hubbard and Lehr).

of time should include the expected decline in economic value during that period.[1563]

642. Second, these parties argue that, when investments in facilities needed to meet a specific level of demand are sunk and irreversible, an incumbent LEC may not be able to recover these costs over the physical life of the facility, because demand may decreaseas new entrants elect to build their own facilities. When entry is possible using current technology, either competition from these entrants, or rate regulation can prevent retail service prices from rising significantly, which will place an effective ceiling on profits. If demand for a service falls in a market in which the incumbent LEC is the only supplier and owner of sunk facilities, however, there will be no corresponding exit of other carriers that will prevent prices and profits from falling. Because of this asymmetric effect of changing market conditions on an incumbent LEC's profits, these parties claim that increasing the uncertainty due to entry in the local exchange market will increase the cost of capital to the incumbent LEC. They then assert that the inability of TSLRIC to account for the risks associated with sunk facilities can lead to understating the true economic cost of an element by a factor of three.[1564] Finally they assert that

---

[1563] We note that USTA seems to present a contradictory argument regarding the expected effect of this issue -- here Hausman claims that prices will decrease rapidly, whereas in our price cap proceeding, USTA sponsored testimony by Christenson that claimed input prices would generally increase at the rate of inflation. USTA comments in CC Docket No. 94-1, at 25-27.

[1564] *See* USTA reply at Attachment 1 (Reply Affidavit of Jerry A. Hausman), p.1.

empirical research that shows firms' hurdle rates in excess of the market cost of capital shows that the considerations of risk associated with sunk investment significantly raises a firm's cost of capital.[1565]

643. *Joint and Common Costs.* Several incumbent LECs contend that a forward- looking, economic cost methodology does not take into account either joint or common costs.[1566] Although a few parties contend that incumbent LECs do not need a mark-up over TSLRIC to recover joint and common costs because incumbents are presumably already recovering these costs,[1567] commenters generally agree that incumbent LECs should be permitted to recover some measure of forward-looking joint and common costs.[1568] These commenters argue that pricing at incremental

---

[1565] *Id.* at 7.

[1566] *See, e.g.*, Bell Atlantic comments at Tab 2 (Declaration of Robert W. Crandall), p.9, reply at Attachment 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), p.6; BellSouth comments at 51; Municipal Utilities comments at 19-21; SBC reply at 24-25; TDS comments at 18-19.

[1567] *See* Telecommunications Resellers Ass'n comments at 39-40; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29, reply at 9-10.

[1568] *See, e.g.*, Ameritech comments at 60; Bell Atlantic comments at 36; Citizens Utilities comments at 19; Cincinnati Bell comments at 24-25; Colorado Commission comments 45-46; DoJ reply at 6; GTE Comments at 61-62; Kentucky Commission comments at 5; Lincoln Tel. comments at 13; Mass. Commission comments at 11-12; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24; SBC comments at 91; Sprint comments at 43-44; AT&T reply at 28; NTIA reply at 19-21; USTA

cost without joint and common costs is economically inefficient because it permits competitors to offer the incumbent LECs' services without making a contribution to the common costs that the LECs incur in offering the service.[1569] They further contend that excluding recovery of joint and common costs will distort technological decisions because the LEC is encouraged to invest in less efficient technologies that have higher incremental costs and lower common costs, which would tend to destroy economies of scope.[1570] Finally, incumbent LECs fear that they will be forced to increase retail rates to recover these unrecovered common costs, while their competitors that do not face such costs will reduce their own prices and have little incentive to invest in facilities of their own.[1571]

644. There is no consensus in the record on the magnitude of the joint and common costs at stake. Although commenters argued that the amount of common costs varies dramatically due to differences in location, network construction, and equipment,[1572] several parties are skeptical that there are significant joint and common costs between network elements given the relative modularity of the

---

reply at 19.

[1569] *E.g.*, BellSouth comments at 52-53; GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.3.

[1570] *See, e.g.*, BellSouth comments at 53; Lincoln Tel. comments at 13.

[1571] *E.g.*, BellSouth comments at 53-54.

[1572] *See, e.g.*, Municipal Utilities comments at 19-20; NARUC reply at 9.

network and associated functions.[1573] These parties contend that, if joint and common costs are incurred, incumbent LECs must quantify them so that a state commission can determine whether and precisely how much contribution is needed.[1574] The Department of Justice asserts that, when developing a TSLRIC for unbundled network elements, it is preferable, where possible, to focus on costs of facilities and network elements rather than services that use those facilities in order to arrive at a more accurate determination of economic costs and to reduce the amount of costs that must be treated as joint or common.[1575] The incumbent LECs disagree with the new entrants' characterization of these costs as *de minimis* and argue that there is no evidence that unrecovered joint and common costs are much lower in the TSLRIC rates for physical elements than a TSLRIC standard based on the cost of providing services.[1576]

645. There is considerable disagreement in the record over the appropriate method of allocating joint and common costs under a TSLRIC approach. AT&T contends that the vast majority of the relevant costs will be causally

---

[1573] *See, e.g.*, AT&T comments at Attachment or Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.13-14; Competition Policy Institute comments at 19; DJ comments at 31-32, reply at 8; Texas Public Utility Counsel comments at 24-25.

[1574] Texas Public Utility Counsel comments at 17-28; Sprint comments at 47- 50.

[1575] DoJ reply at 8; *see also* Competition Policy Institute comments at 19.

[1576] *E.g.*, PacTel reply at 27; *see also* Cincinnati Bell reply at 10.

attributed to particular network elements in the calculation of TSLRIC, and that we should prescribe rigid allocators that limit the incumbents' ability to manipulate prices by imposing high markups on new entrants.[1577] This approach, it is argued, is more competitively neutral than Ramsey pricing, which allocates costs based on inverse demand elasticity.[1578] In contrast, incumbent LECs advocate allocation of joint and common costs based on inverse demand elasticity,[1579] *i.e.*, according to Ramsey pricing principles.[1580] New entrants and other parties oppose the use of Ramsey pricing for interconnection and unbundled network elements for use in a market that is moving toward competition over the long-run.[1581] They contend that Ramsey pricing enables LECs to shift costs associated with entry into new competitive markets

---

[1577] *See* AT&T comments at 61-62.

[1578] *See, e.g.*, Teleport comments at 47-48.

[1579] *See e.g.*, GTE comments at 63, comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), pp.4-6; *see also* Mass. ommission comments at 11- 12.

[1580] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991).

[1581] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 39-41; CompTel comments at 79-80; MECA comments at 45; Teleport comments at 47-48; Texas Public Utility Counsel comments at 27; WinStar reply at 10-11.

over to captive services.[1582] One state commission responds that the Commission's concern in this regard would be addressed by calculating demand elasticities on the basis of the total industry demand for the service, which would negate the influence of competition on demand elasticities.[1583]

646. Commenters suggested other means of allocating joint and common costs. For example, certain incumbent LECs argue that these costs must not be shifted from interconnection and unbundled elements to residential subscribers,[1584] while certain new entrants suggest that these costs should be recovered at the retail level.[1585] Many new entrants agree that the Commission should require allocation of joint and common costs that minimizes the opportunity for incumbent LECs to harm competitors through strategic pricing.[1586] For example, some new entrants argue that states should be required to minimize allocation of joint and common costs to bottleneck or essential network elements.[1587]

[1582] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 38-39.

[1583] *See, e.g.*, Mass. Commission comments at 12.

[1584] *See, e.g.*, Puerto Rico Tel. comments at 10; Rural Tel. Coalition comments at 27.

[1585] *E.g.*, MCI reply at 9-10.

[1586] *See, e.g.*, MCI reply at 9-10.

[1587] *See, e.g.*, LCI comments at 4-5 (even under a TSLRIC methodology, it may be necessary to allocate joint direct costs among classes of service); Time Warner comments at 52-53 (only elements that can be duplicated by competitors or that are already available from other

MCI and Sprint assert that such costs should be spread across all services provided by a carrier in proportion to the TSLRIC for each service.[1588] A few commenters assert that the Commission should adopt a fixed mark-up over TSLRIC for allocation of joint and common costs.[1589] Cable & Wireless supports the adoption of a rule that allocates common costs uniformly for all services offered. It argues that a disproportionate allocation system, that for example, assigns common costs strictly to retail services purchased for resale by small companies, but not to unbundled network elements utilized by larger competitors, would prove detrimental to the development of local competition.[1590] Finally, certain parties suggested that regardless of the method ultimately used to allocate joint and common costs, TSLRIC should serve as the floor[1591] and prices should not exceed stand-alone costs.[1592]

---

sources should include a reasonable markup over TSLRIC for shared and common costs); *see also* CFA/CU comments at 33-35 (allocation to such elements should be no more than the allocation of such costs to basic service).

[1588] *See* AT&T comments at 64; MCI reply at 9-10; Sprint comments at 47.

[1589] *See, e.g.*, Competition Policy Institute comments at 19 (suggesting an overhead loading of six percent); *see also* Sprint comments at 48-49 (joint and common costs should be no more than 15 percent of TSLRIC)

[1590] Cable & Wireless comments at 35.

[1591] *See, e.g.*, Citizens Utilities comments at 19; Florida Commission comments at 26; SBC comments at 93-94.

[1592] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.14-15; TDS

647. *Reasonable Profit.* Commenters disagree over what should constitute a "reasonable profit." Numerous commenters argue that a TSLRIC-based methodology for the pricing of interconnection and unbundled network elements includes a reasonable profit and is, therefore, consistent with the 1996 Act.[1593] These commenters argue that economic measures, such as TSLRIC, reflect a reasonable profit by including the cost of capital.[1594] Time Warner and NEXTLINK contend that permitting incumbent LECs to receive a profit above that contained within TSLRIC pricing would provide them with a greater return on facilities than was permitted under rate-of-return regulation by "double-counting" the profit.[1595] Furthermore, NEXTLINK rejects the notion that profit includes the recovery of embedded costs or is a means of recovering subsidies for universal service currently recovered through access charges such as the transport interconnection charge or carrier common line charge, or their intrastate equivalents.[1596] Similarly, LDDS

---

comments at 21.

[1593] *See, e.g.*, CompTel comments at 69-70; LDDS comments at 61; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29; Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p. 12.

[1594] *E.g.*, AT&T reply at 31; CompTel comments at 69-70, reply at 39; DoJ reply at 9; Frontier reply at 12-15; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29.

[1595] NEXTLINK comments at 28; Time Warner reply at 31-32.

[1596] NEXTLINK comments at 28-29.

believes that "reasonable profit" cannot be read to include contribution to costs having nothing to do with providing the network elements or interconnection that are the subject of a section 252 pricing standard.[1597]

648. Incumbent LECs, however, contend that setting rates on a TSLRIC-based methodology alone would violate section 252(d)(1) by precluding recovery of a reasonable profit.[1598] NYNEX and USTA state that profit is what a firm makes after it recovers its total costs of providing all of its services, including its investment-related costs.[1599] Ameritech similarly contends that the term "reasonable profit" means the ability to earn positive economic profits as an incentive for efficiency and innovation.[1600] PacTel argues that, in order to allow for a reasonable profit, rates for interconnection and unbundled elements must permit full recovery of historical accounting costs. PacTel charges that the federal courts have held that the determination of a "reasonable profit" should consider the effect on the carrier's

---

[1597] LDDS comments at 61.

[1598] *See, e.g.*, GTE comments at 60; NYNEX comments at 51-52; PacTel comments at 69; SBC comments at 88; TCA comments at 9; TDS comments at 18; *see also* GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.9.

[1599] *See* NYNEX comments at 42; USTA comments at 43.

[1600] *See* Ameritech comments at 70-71.

whole enterprise and, therefore, the sum of the carrier's rates must enable it to recover its total historical costs.[1601]

649. Several parties contend that the issue of what constitutes a reasonable profit should be left to the states. Citizen Utilities contends that the issue of whether profit is reasonable is a question of fact to be resolved, where necessary, in arbitration proceedings.[1602] Time Warner argues that what constitutes reasonable profit should, as a matter of policy, vary depending on the nature of the facilities or services being provided and should, therefore, be left to the states.[1603] The Illinois Commission argues that states may even use rate-of-return methodologies for the determination of reasonable profit.[1604]

650. There is also disagreement among the commenters regarding the force of the reasonable profit language in section 252. While many incumbent LECs interpret Section 252(d)(1) as *requiring* prices to include a reasonable profit,[1605] certain new entrants and other parties argue that the reasonable profit language is permissive, not

---

[1601] *See* PacTel comments at 65-66, *citing FPC v. Hope Natural Gas*, 320 U.S. 591 (1944) and *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1172 (D.C. Cir. 1987).

[1602] Citizens Utilities comments at 17.

[1603] Time Warner comments at 52.

[1604] Illinois Commission reply at 15.

[1605] *See, e.g.*, PacTel comments at 65-66.

mandatory.[1606] For example, several LECs contend that, to avoid confiscation of their property, LECs are entitled to full operating expenses as well as the capital costs of doing business and a reasonable profit.[1607] The Ohio Consumers' Counsel, however, argues that the language of section 252(d)(1) indicates that it is at the discretion of the state commissions to determine whether to allow rates to reflect a reasonable profit.[1608]

651. USTA contends that "purely forward-looking TSLRIC" should not be the price for interconnection elements because "telecommunications networks are mostly sunk costs."[1609] It argues that, when investment in facilities requires sunk and irreversible costs, a firm may not be able to recover this investment over the physical life of the facilities due to the risks of decreases in value resulting from future competition. USTA contends that allowing other carriers into the provision of local exchange service will subject incumbent LECs to these types of risks. It then claims that TSLRIC calculations do not appropriately account for these additional risks.

652. USTA also argues that the risks to which the incumbent LECs will be subject as a result of competition in

---

[1606] *See, e.g.*, AT&T reply at 31; Cox reply at 29; DoJ reply at 15.

[1607] *See, e.g.*, MECA comments at 44, 49; PacTel comments at 65-67.

[1608] Ohio Consumers' Counsel comments at 26.

[1609] *See* USTA reply at Attachment 1 (Reply Affidavit of Professor Jerry A. Hausman), p.1.

the local exchange market include the risks from facing new competition, technological change, change in demand, and interest rates. It further argues that these risks will result in many situations in which the incumbent LECs may face a reduction in profits (downside risk) and no situations in which the incumbent LECs may see an increase in their profits. Thus, incumbent LECs must be compensated for these additional risks, according to USTA. It concludes that TSLRIC calculations fail to provide this compensation, stating "TSLRIC can be biased downward by a factor of three."[1610]

653. Similarly, Bell Atlantic asserts that, in a market where input prices are declining, a TSLRIC standard is not the appropriate standard because, "in a world of continual technological progress, it would be irrational for firms constantly to update their facilities in order completely to incorporate today's lowest-cost technology."[1611] Thus, it argues that because a carrier would not replace its entire existing set of facilities (a sunk investment) with the best available technology at a given point, the price of the best available technology understates the cost of providing service.[1612]

[1610] *Id.* at 6. Presumably, by TSLRIC, Professor Hausman is referring to a TSLRIC assuming a risk free rate of return and a depreciation rate that encompasses the physical life of assets.

[1611] Bell Atlantic reply at Exhibit 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), para.8a.

[1612] *Id.*

654. The Consumer Federation of America, disputing the incumbent LECs' claims regarding risk premiums, argues that risk premiumsare reflected in the large returns incumbent LECs have already earned.[1613]

655. *Embedded Costs.* IXCs, competitive local entrants, and others interpret section 251(d)(1) as precluding states from setting rates by use of traditional cost-of-service regulation, with its detailed examination of historical accounting costs and reliance on an embedded rate base.[1614] These parties argue that some measure of forward-looking economic costs, not historical costs, should be the only basis for setting rates for interconnection and unbundled network elements because only forward-looking economic costs meet the statutory requirement in section 252(d)(1) that such rates be "determined without reference to a traditional rate-of-return or other rate-based proceeding." Potential new entrants and many other commenters argue that historical or embedded costs should not be included in the prices of

---

[1613] *See* CFA/CU comments at 61-63.

[1614] *See, e.g.*, AT&T comments at 47; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Sprint comments at 43; Teleport comments at 46; Time Warner comments at 51; Frontier comments at 21; Excel comments at 9; ACSI comments at 54-55; WinStar comments at 37-38; GST comments at 29-30; *see also* Ad Hoc Telecommunications Users Committee comments at 30-31; DoJ comments at 27-32, reply at 14; Kentucky Commission comments at 4; Texas Public Utility Counsel comments at 33-34; Telecommunications Resellers Ass'n comments at 38; Michigan Commission comments at 14; Pennsylvania Commission comments at 29; Ohio Commission comments at 42-43; Attorneys General reply at 7-8.

interconnection and unbundled network elements.[1615] NTIA asserts that it is unwise to include in the prices for interconnection and unbundled elements an amount to recover historical costs when the size of any shortfall between historical costs and TSLRIC's forward-looking costs will not be determined for many years after interLATA entry.[1616] These parties contend that permitting incumbent LECs to recover embedded costs in the prices they charge competitors for interconnection and unbundled network elements, while the incumbents experience much lower incremental costs, will result in inefficiently high prices that will either cause new entrants to over-build existing systems instead of maximizing the efficient use of the existing incumbent LEC's network, or discourage entry and investment in the local markets altogether.[1617] Moreover, opponents of embedded cost recovery maintain that these costs reflect past inefficiencies and their recovery does not create any incentive for incumbent LECs to maximize their network and operational

---

[1615] *See, e.g.*, AT&T comments at 47; CFA/CU reply at 18-19; DoJ comments at 27-32; N. Economides comments at 3; Frontier comments at 21-22, reply at 13; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Michigan Commission comments at 14; Sprint comments at 43; Teleport comments at 46; TCC comments at 15-16; Texas Public Utility Counsel comments at 33-34; Time Warner comments at 51; WinStar comments at 37-38; *see also* Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), pp.2-6;

[1616] *See* NTIA reply at 28-29.

[1617] *See, e.g.*, Competition Policy Institute comments at 8; TCC comments at 15-16.

efficiencies.[1618] Commenters also argue that embedded cost recovery permits incumbents to engage in anticompetitive, strategic, or discriminatory pricing by manipulating the cost of individual rate elements.[1619]

656. In response to claims that the incumbent LECs are entitled to recover embedded costs incurred as a result of their regulation, opponents of embedded cost recovery argue that, at the state level, incumbent LECs have been opting for incentive-based regulation and so have foregone the right to claim entitlement to recovery of embedded costs in exchange for the flexibility to price their services to meet competition.[1620] AT&T argues that, because the majority of the incumbent LECs' embedded plant was installed after 1990, the forward-looking replacement costs of this old plant may in many cases be higher than the incumbent LECs' embedded costs.[1621] MCI disagrees with incumbent LECs' claims that excluding historical costs will discourage future investment by incumbent LECs and argues instead that incumbent LECs make investment decisions based upon expected future earnings.[1622]

[1618] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 53-54.

[1619] TCC comments at 15-16

[1620] *See, e.g.*, GST comments at 29-30; WinStar comments at 38.

[1621] *See* AT&T reply at 33. For a detailed discussion, *See* AT&T reply at Appendix C (Affidavit of Lee Selwyn and Patricia Kravtin), pp.1-4.

[1622] *See* MCI reply at 15-16.

657. Most incumbent LECs and some other parties dispute the claim that historical costs are precluded by the statute,[1623] asserting instead that section 252(d)(1) merely prohibits the use of a rate-of-return *proceeding* to determine such rates.[1624] Incumbent LECs argue that any pricing methodology the Commission adopts should permit recovery of historical or embedded costs in the prices of interconnection and unbundled network elements.[1625] NYNEX specifically proposes a cost-accounting pricing methodology that places the burden on the incumbent LEC to identify the specific accounting data that would be associated with the particular type of interconnection requested by the competing carrier under section 251.[1626]

[1623] *See, e.g.*, Bell Atlantic comments at 37; BellSouth reply at 35-37; Colorado Commission comments at 34-35; GVNW comments at 35-36; Municipal Utilities comments at 19; NYNEX comments at 46-47; Ohio Consumers' Counsel comments at 23; PacTel comments at 65; Roseville Tel. comments at 6-8; Rural Tel. Coalition comments at 26-28; SBC comments at 88; TDS comments at 17-18; Texas Statewide Telephone Coop. Inc. comments at 7; USTA comments at 40.

[1624] *See, e.g.*, Bell Atlantic comments at 37; Municipal Utilities comments at 19; Ohio Consumers' Counsel comments at 23; Texas Statewide Telephone Coop. comments at 7.

[1625] *See, e.g.*, Alaska Tel. Ass'n comments at 4-5; Ameritech comments at 60; Bell Atlantic comments at 36; Cincinnati Bell comments at 30; Lincoln Tel. comments at 11-12; Roseville Tel. comments at 7-8; SBC comments at 59; SNET comments at 29; USTA comments at 40; *see also* NECA comments at 6, reply at 8-9.

[1626] NYNEX comments 54-56, reply at 27.

658. USTA cites reports that estimate that embedded costs that would not be recouped under a solely forward-looking pricing methodology are between $13 billion and $18.4 billion.[1627] Incumbent LECs contend that, because incumbent LECs must offset this shortfall of revenues against total costs that is created by a failure to recover embedded costs, they will be discouraged from investing to maintain and upgrade their networks in order to avoid the risk of again being unable to recover embedded costs.[1628] In addition, they argue that they incurred these embedded costs under federal and state regulatory oversight, which imposed on incumbent LECs social policy obligations and uneconomic costing practices, and that they therefore should be permitted to recover them.[1629] Incumbent LECs also assert that past investments were made under the belief that costs would be recovered, and that rates collected in the past did not reflect the risk that embedded costs might not be recovered in future rates.[1630] Several commenters argue that the opportunity to recover embedded costs through rates for interconnection and unbundled elements is particularly important for small and

---

[1627] USTA comments at 55.

[1628] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Professor Jerry A. Hausman), p.2; Lincoln Tel. comments at 16-17; USTA reply at 23.

[1629] *See, e.g.*, Ameritech reply at 30-31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

[1630] *See* Bell Atlantic reply at Exhibit 2 (Declaration of Richard A. Epstein), p.4.

rural incumbent LECs.[1631] Finally, some parties also contend that, if they are not permitted to recover embedded costs, these costs must be recouped elsewhere, thus putting pressure on the states to recover these costs through local rates.[1632]

659. Despite their objections to embedded cost recovery, some non-incumbent parties explain conditions under which some limited recovery should be permitted. For example, MCI argues that, although embedded costs should not be recovered, it would be appropriate to allow incumbent LECs to recover any depreciation reserve deficiency,[1633] which MCI estimates is only a small percentage of the residual between existing revenues and the revenues generated by a forward-looking, TSLRIC pricing of unbundled network elements.[1634] The Ad Hoc Telecommunications Users Committee asserts that, at a

---

[1631] *E.g.*, Home Tel. comments at 4; NECA comments at 9; TCA comments at 8; Texas Statewide Tel. Cooperative, Inc. comments at 9; Bay Springs reply at 10.

[1632] *See, e.g.*, USTA comments at 56; Wyoming Commission comments at 31-32; *see also* New York Commission reply at 9; *cf.*, Alabama Commission comments at 24-25; Texas Commission comments at 23, 26.

[1633] A reserve imbalance exists when the carrier's actual "book" depreciation reserve differs from its "theoretical" reserve, which is the reserve which would exist if service lives and salvage values had been accurately forecast in the past. When the theoretical reserve exceeds the book reserve, the imbalance is a reserve deficiency. For most LECs the reserve imbalance is an overall deficiency. *Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers*, CC Docket No. 87-447, Report and Order, 3 FCC Rcd 984 (1988).

[1634] *See* MCI comments at 73-75.

minimum, any nominal losses in economic value attributed to stranded investment should be weighed against the appreciation in value that incumbent LECs have experienced as reflected in share prices and market-to-book ratios.[1635] The Consumer Federation of America proposes that stranded investment might be recovered through an industry-wide recovery fund, if incumbent LECs can satisfy a rigorous set of showings to ensure that ratepayers are fairly treated.[1636] Finally, AT&T argues that, if the Commission determines that some portion of the residual should be recovered, it should be recovered through a competitively neutral, transitional, funding and distribution mechanism that will not distort competition.[1637]

660. *Opportunity Cost -- ECPR.* Incumbent LECs are the primary advocates for ECPR pricing of interconnection and unbundled network elements.[1638] They argue generally that ECPR is the approach that most closely parallels the method a firm in a competitive market would employ when faced with the opportunity of selling inputs to firms that intend to compete with it in its final product

---

[1635] Ad Hoc Telecommunications Users Committee comments at 26-27.

[1636] *See* CFA/CU comments at 67-68.

[1637] *See* AT&T comments at 70-73.

[1638] *See, e.g.*, Ameritech comments at 91-93; GTE reply at 36-38; MECA comments at 50-52; PacTel comments at 69-71; SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5; *see also* PacTel reply at Appendix C (Declaration of Richard D. Emerson).

market.[1639] GTE asserts that the ECPR's purpose is to reward efficient entry into the market for the end product by ensuring that the incumbent LEC sells network access to itself and to its rivals on the same, nondiscriminatory terms.[1640] Thus, GTE claims, the ECPR sets prices for network elements that provide incentives for efficient entry and compensates incumbent LECs for the economic costs associated with sale of such elements.[1641] GTE further argues that ECPR accomplishes these tasks regardless of the market structure and regardless of the presence or absence of economic rents.[1642] SBC arguesm that the ECPR is equivalent to the avoided cost rule used for setting the prices of resold services and equivalent to the efficient imputation rule for pricing of retail services.[1643] Supporters of ECPR pricing also argue that prices will continue to move toward competitive levels where competition is provided by a more efficient carrier than the incumbent LEC.[1644]

[1639] *See, e.g.*, Rural Tel. Coalition reply at 28-30.

[1640] GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.7.

[1641] *Id.* at p.I-i

[1642] *Id.* at p.III-7.

[1643] SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5.

[1644] *See, e.g.*, Ameritech comments at 93; GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.III-6-8.

661. New entrants and many other commenters oppose the use of the ECPR to set prices for interconnection and access to unbundled network elements.[1645] These parties argue that ECPR does not comply with the statutory mandate that interconnection and network elements be based on costs. They assert that using ECPR would allow incumbent LECs to retain monopoly rents and protect the incumbent LECs from competitive disciplinary market forces.[1646] Opponents of ECPR contend that ECPR pricing does not replicate a competitive environment, but instead perpetuates inefficient and anticompetitive aspects of the current pricing structure. Other commenters argue that the incumbent LECs may use ECPR to exclude or marginalize a more efficient rival in the complementary market by forcing the rival to operate on the higher end of its cost curve through higher interconnection charges. They also argue that prices based on ECPR create incentives for incumbent LECs to shift costs of their competitive services to their bottleneck services, which

---

[1645] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 55; ALTS reply at 26-29; Cable & Wireless comments 35; California Commission reply at 20; CFA/CU comments at 41-45; CompTel reply at 40-49; Cox reply at 29; DoJ reply at 11-13; Frontier comments at 23; Mass. Attorney General comments at 6- 9; MCI comments at 70-71, reply at 16; MFS comments at 60 n.67; Ohio Consumers' Counsel comments at 25 n.7, reply at 15; Sprint comments at 59 n.33; Texas Public Utility Counsel comments at 36; Time Warner comments at 56-58; Telecommunications Resellers Ass'n comments at 41-42; WinStar comments at 41.

[1646] *See, e.g.*, Cable & Wireless comments 35; California Commission reply at 20; CompTel reply at 40; Mass. Attorney General comments at 6-8; Time Warner comments 56-58; Telecommunications Resellers Ass'n comments at 41-42.

distorts competition.[1647] Finally, opponents of ECPR assert that ECPR pricing shields the largest share of costs possible from competition, preserves the status quo, and imposes a barrier to entry.[1648]

662. Baumol, Ordover, and Willig, principal authors of the theory, explain that ECPR is not applicable for pricing of interconnection and unbundled network elements because the existing end user rates for local telecommunications are not appropriate as a baseline for ECPR. They claim that cross-subsidies are common in the current rates, and rates depart systematically from pertinent costs. Baumol, Ordover, and Willig conclude that applying ECPR to existing rates would result in component prices that lock in the incumbent LECs' monopoly profits and pricing inefficiencies, and would attract inefficient entry, where rates are too high, and would preclude efficient entry where rates are too low.[1649]

663. *Universal Service Subsidies.* Most parties other than incumbent LECs and some state commissions agree that it would be inconsistent with both the cost- based rate requirements of section 252(d)(1) and the requirement in section 254(b)(5), that universal service support mechanisms

---

[1647] *See, e.g.*, N. Economides comments at 4-6.

[1648] *See, e.g.*, CFA/CU comments at 42.

[1649] *See* AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.8-9.

"be specific [and] predictable..."[1650] for states to include any universal service subsidies in the rates they set for interconnection, collocation, and unbundled network elements.[1651] They argue that the 1996 Act requires that rates reflect the economic cost of providing network elements and interconnection and does not authorize subsidies that have nothing to do with economic costs.[1652] With regard to the requirements of section 254, these parties argue that, to the extent rates need to be subsidized for universal service purposes, the subsidy should be collected from all carriers on a non-discriminatory and competitively neutral basis.[1653] The Washington Commission relates its own experience of rejecting US West's request for a per minute universal service charge to cover "carrier of last resort" obligations and its

---

[1650] 47 U.S.C. § 254(b)(5).

[1651] *See, e.g.*, ACTA comments at 23; AT&T comments at 70-73; Competition Policy Institute comments at 20; CompTel comments at 73-74; DoJ comments at 56- 59; MCI comments at 75; NEXTLINK comments at 29; Sprint comments at 61-62; Telecommunications Resellers Ass'n comments at 39 n.76; Teleport comments at 48-49; WinStar comments at 40-41, reply at 13-14.

[1652] AT&T and CompTel further contend that to permit any universal service subsidies in the rates set for interconnection, collocation and unbundled network elements would be to base rates on the embedded costs of incumbent LEC expenditures rather than the forward-looking economic costs of providing a network element as mandated by section 252(d)(1). *See* AT&T comments at 70- 73; CompTel comments at 72-74.

[1653] *See, e.g.*, ACTA comments at 23; AT&T comments at 69; Massachusetts Commission comments at 8-10; MCI comments at 75; Michigan Commission comments at 19.

finding that residential rates were sufficient to cover the costs of residential service.[1654]

664. In contrast, several incumbent LECs and state public utility commissions maintain that incumbent LECs should be permitted to recover their embedded costs in the rates set for interconnection, collocation, and unbundled network elements. These commenters claim that rates based on incremental costs alone fail to account for certain costs historically incurred to accomplish carrier- of-last-resort and universal service social policy objectives.[1655] The Attorneys General caution the Commission not to classify legitimate contributions to joint and common costs as impermissible implicit universal service subsidies.[1656]

665. Several parties comment on the issue of how universal service funding should be handled during the interim period between the effective date of this order and the effective date of the Commission's order implementing the section 254 universal service requirements in May 1997. AT&T proposes that the Commission adopt a competitively-

---

[1654] Washington Commission reply at 6.

[1655] *See, e.g.*, Alabama Commission comments at 24-25; Bay Springs, *et al.* comments at 16; BellSouth comments at 57; Matanuska Tel. comments at 2-3; TDS comments at 20; SBC comments at 89; Western Alliance comments at 6-7; *but see* BellSouth comments at 57 (if the universal service proceeding establishes a federal fund or if the states establish explicit funds, there will be no need for subsidies to be built into interconnection and unbundled network element rates).

[1656] Attorneys General reply at 10-11.

neutral funding and distribution mechanism.[1657] CompTel proposes that the Commission grant a blanket waiver of incremental cost pricing for exchange access. Under CompTel's plan, pending completion of the section 254 proceeding, the incumbent LECs would continue to provide exchange access pursuant to their intrastate and interstate carrier-to- carrier access charge tariffs. At the conclusion of the section 254 proceeding, the Commission would determine whether the incumbent LECs are entitled to recover any portion of those revenues from competitive carriers and, if so, devise appropriate mechanisms for doing so. CompTel asserts that, by preserving the status quo for exchange access until those issues are fully considered and resolved, the Commission would ensure that the 1996 Act does not cause any unnecessary short-term disruption to carriers or consumers.[1658]

666. The Western Alliance contends that states should have authority to order the recovery of lost contribution through access charges until explicit and competitively neutral support mechanisms are in place.[1659] Similarly, the Massachusetts Commission argues that the states should have authority to include universal service subsidies in the rates for interconnection during this period. The Massachusetts Commission further contends that prohibiting states from exercising this authority will promote

---

[1657] AT&T comments at 73.

[1658] CompTel comments at 84.

[1659] FN1659. Western Alliance comments at 6-7.

inefficient competition and ultimately could result in confiscation claims being filed by incumbent LECs.[1660]

667. Some parties take the position that "play or pay" proposals incorporate implicit subsidies into rates for interconnection and unbundled network elements and are therefore inconsistent with the 1996 Act.[1661] They further argue that such programs violate the 1996 Act because they do not require all telecommunications carriers to contribute on an equitable and nondiscriminatory basis and do not qualify as "specific, predictable and sufficient mechanisms" to preserve and advance universal service.[1662]

668. Other commenters argue, however, that the 1996 Act permits reasonable differences in interconnection rates charged to carriers so long as similarly- situated carriers are treated alike. They maintain that the anti- discrimination provisions of the 1996 Act only prohibit unreasonable discrimination. Thus, they contend that "play or pay" schemes are consistent with the 1996 Act.[1663] Several parties also contend that such schemes are authorized by the reservation of state power to adopt and implement universal

---

[1660] Mass. Commission comments at 9-10.

[1661] *See, e.g.*, Frontier comments at 23; Teleport comments at 48-49; Texas Public Utility Counsel comments at 35-36; WinStar reply at 14 n.20.

[1662] WinStar comments at 40; *see also* Texas Public Utility Counsel comments at 35.

[1663] *See, e.g.*, New York Commission comments at 15-18; NYNEX comments at 91- 97.

service measures in section 254.[1664] Moreover, the New York Commission argues that the section 254(e) requirement that universal service funding must be explicit applies only to the federal Universal Service Fund, which is yet to be established, and not to state initiatives.[1665]

669. Some commenters urge the Commission to address universal service in the section 254 proceeding rather than in the section 251/252 interconnection proceeding.[1666] Other commenters suggest that universal service, access restructure, and interconnection issues should be addressed in a coordinated manner or in a consolidated proceeding.[1667]

670. *Fifth Amendment Issues*. Several incumbent LECs claim that use of a LRIC-based pricing methodology that does not permit recovery of at least joint and common costs and a reasonable profit constitutes unlawful confiscation in violation of the Fifth and Fourteenth Amendments.[1668] Other LECs further argue that, in order to avoid an unconstitutional taking, any pricing rules we adopt must

---

[1664] NYNEX comments at 95-97; New York Commission reply at 6.

[1665] New York Commission reply at 6.

[1666] *See, e.g.*, Competition Policy Institute comments at 13-14; F. Williamson comments at 8; Texas Public Utility Counsel comments at 36; ALTS reply at 35.

[1667] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 35; TDS comments at 20.

[1668] *See, e.g.*, GTE comments at 65-71; MECA comments at 42; Puerto Rico Telephone Company reply at 11-12; PacTel comments at 67.

enable them to recover total costs, including historical or embedded costs.[1669] Generally, these parties contend that prices limited by a forward-looking economic cost methodology do not permit an incumbent LEC to remain profitable over time because LRIC fails to recover total costs.[1670] They assert that, if the Commission decides now, long after those costs have been sunk, to bar compensatory returns, it will violate due process and undermine the incumbent LECs' legitimate, investment-backed expectations.[1671] Such interference with legitimate investor expectations, they contend, constitutes an unlawful taking.[1672] GTE contends that Commission adoption of a pure TSLRIC methodology would represent an unconstitutional taking, because it would require use of the incumbent LEC's physical property, thus giving rise to an obligation to provide just compensation.[1673]

671. Other parties, including the Department of Justice and new entrants, contend that using a forward-looking cost-based pricing methodology for setting the rates for interconnection and unbundled elements does not

---

[1669] *See, e.g.*, NYNEX comments at 43-44; PacTel comments at 65-66; SNET comments at 29; Roseville Tel. comments at 6-7.

[1670] *See, e.g.*, Ameritech comments at 62-70; GTE comments at 68-71, reply at 31-32; USTA comments at 39-42.

[1671] *See, e.g.*, GTE comments at 66-71, reply at 31-33; USTA comments at 40- 45, reply at 21-25, 32-34.

[1672] *Id.*

[1673] *See* GTE comments at 65-67.

constitute an unlawful taking.[1674] These commenters point out that many state commissions already utilize a forward-looking cost-based pricing methodology.[1675] They also argue that, because forward-looking cost-based rates capture all costs for interconnection and unbundled network elements, including the risk-adjusted cost of capital, such a methodology would not result in an unlawful taking.[1676] These parties further assert that the LECs' takings claims are premature, not demonstrated with sufficient specificity, and overstate the scope of the constitutional guarantee.[1677] Commenters note that no incumbent LEC has made any effort to demonstrate the actual impact of a LRIC-based pricing methodology on its "financial integrity."[1678] These parties contend that there is no unconstitutional impairment if the shortfall is not sufficient to jeopardize the operating and financial integrity of the utility. Finally, these commenters maintain that there is no constitutional right to a particular rate-setting methodology (*i.e.*, historical cost) and there are no general principles that

---

[1674] *See, e.g.*, ALTS reply at 8-11; AT&T comments at 70-71; CompTel reply at 37-40; DoJ reply at 13, 16-19; MCI reply at 18-20.

[1675] *See, e.g.*, AT&T comments at 49-50; Cable & Wireless reply at 24-25; MCI reply at 19. AT&T also notes that when U S West and BellSouth have been new entrants into markets, they have advocated a LRIC approach. AT&T comments at 50-51 n.72.

[1676] *See, e.g.*, Frontier reply at 14; MCI reply at 18-19.

[1677] *See, e.g.*, DoJ reply at 16-18.

[1678] DoJ reply at 16-18; MCI reply at 18.

require every component of an integral whole of a utility service to show a profit.[1679]

(3) Discussion

672. *Overview.* Having concluded in Section II.D., above, that we have the requisite legal authority and that we should establish national pricing rules, we conclude here that prices for interconnection and unbundled elements pursuant to sections 251(c)(2), 251(c)(3), and 252(d)(1), should be set at forward-looking long-run economic cost. In practice, this will mean that prices are based on the TSLRIC of the network element, which we will call Total Element Long Run Incremental Cost (TELRIC), and will include a reasonable allocation of forward-looking joint and common costs. The 1996 Act encourages competition by removing barriers to entry and providing an opportunity for potential new entrants to purchase unbundled incumbent LEC network elements to compete efficiently to provide local exchange services. We believe that the prices that potential entrants pay for these elements should reflect forward- looking economic costs in order to encourage efficient levels of investment and entry.

673. In this section, we describe this forward-looking, cost-based pricing standard in detail. First, we define the terms we are using, explain how the methodology we are adopting differs from other costing approaches, and describe how it should be implemented. In particular, we explain that the price of a network element should include the forward-looking costs that can be attributed directly to the

[1679] *See, e.g.*, Jones Intercable reply at 16-17.

provision of services using that element, which includes a reasonable return on investment (*i.e.*, "profit"), plus a reasonable share of the forward-looking joint and common costs. Second, we address potential cost measures that must not be included in a TELRIC analysis, such as embedded (or historical) costs, opportunity costs, or universal service subsidies. Finally, we refute arguments that this methodology would violate the incumbent LECs' rights under the Fifth Amendment.

(a) Total Element Long Run Incremental Cost

674. *Definitions of Terms.* In light of the various possible definitions of a number of the critical economic terms used in this context, we begin by defining terms as we use them in this Order. Specifically, we provide definitions for the following terms: "incremental cost;" "economic cost;" "embedded or accounting cost;" "joint cost;" "common cost;" "long run incremental cost;" "total service long run incremental cost;" "total element long run incremental cost." In addition to defining these terms, we explain the economic rationale behind the concepts.

675. Incremental costs are the additional costs (usually expressed as a cost per unit) that a firm will incur as a result of expanding the output of a good or service by producing an additional quantity of the good or service.[1680] Incremental costs are forward-looking in the sense that these costs are incurred as the output level changes by a given

[1680] *See* 1 Alfred Kahn *The Economics of Regulation* 66 (1971); William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

increment.[1681] The costs that are considered incremental will vary greatly depending on the size of the increment. For example, the incremental cost of carrying an additional call from a residence that is already connected to the network to its end office is virtually zero. The incremental cost of connecting a new residence to its end office, however, is the cost of the loop. Forward-looking incremental costs, plus a portion of the forward-looking joint and common costs, are sometimes referred to as "economic costs." Embedded or accounting costs are costs that firms incurred in the past for providing a good or service and are recorded as past operating expenses and depreciation. Due to changes in input prices and technologies, incremental costs may differ from embedded costs of that same increment. In competitive markets, the price of a good or service will tend towards its long-run incremental cost.

676. Certain types of costs arise from the production of multiple products or services. We use the term "joint costs" to refer to costs incurred when two or more outputs are produced in fixed proportion by the same production process (*i.e.*, when one product is produced, a second product is generated by the same production process at no additional cost). The term "common costs" refers to costs that are incurred in connection with the production of multiple products or services, and remains unchanged as the relative proportion of those products or services varies (*e.g.*, the salaries of corporate managers). Such costs may be common to all services provided by the firm or common to only a subset of those services or elements. If a cost is common with

---

[1681] William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

respect to a subset of services or elements, for example, a firm avoids that cost only by not providing each and every service or element in the subset. For the purpose of our discussion, we refer to joint and common costs as simply common costs unless the distinction is relevant in a particular context.

677. The term "long run," in the context of "long run incremental cost," refers to a period long enough so that all of a firm's costs become variable or avoidable.[1682] The term "total service," in the context of TSLRIC, indicates that the relevant increment is the entire quantity of the service that a firm produces, rather than just a marginal increment over and above a given level of production. Depending on what services are the subject of a study, TSLRIC may be for a single service or a class of similar services. TSLRIC includes the incremental costs of dedicated facilities and operations that are used by only the service in question. TSLRIC also includes the incremental costs of shared facilities and operations that are used by that service as well as other services.

678. While we are adopting a version of the methodology commonly referred to as TSLRIC as the basis for pricing interconnection and unbundled elements, we are coining the term "total element long run incremental cost" (TELRIC) to describe our version of this methodology. The incumbent LEC offerings to be priced using this methodology

---

[1682] *See, e.g.*, William Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977) ("The very long run is a period so long that all of the firm's present contracts will have run out, its present plant and equipment will have been worn out or rendered obsolete and will therefore need replacement, etc.").

generally will be "network elements," rather than "telecommunications services," as defined by the 1996 Act.[1683] More fundamentally, we believe that TELRIC-based pricing of discrete network elements or facilities, such as local loops and switching, is likely to be much more economically rational than TSLRIC-based pricing of conventional services, such as interstate access service and local residential or business exchange service. As discussed in greater detail below, separate telecommunications services are typically provided over shared network facilities, the costs of which may be joint or common with respect to some services. The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are able to provide the other at no additional cost. By contrast, the network elements, as we have defined them,[1684] largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services. Because it is difficult for regulators to determine an economically-optimal allocation of any such joint and common costs, we believe that pricing elements, defined as facilities with associated features and functions, is more reliable from the standpoint of economic efficiency than pricing services that use shared network facilities.

[1683] 47 U.S.C. §§ 3(29), 3(46).

[1684] *See supra* Section V.

679. *Description of TELRIC-Based Pricing Methodology*. Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market. In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior. Congress recognized in the 1996 Act that access to the incumbent LECs' bottleneck facilities is critical to making meaningful competition possible. As a result of the availability to competitors of the incumbent LEC's unbundled elements at their economic cost, consumers will be able to reap the benefits of the incumbent LECs' economies of scale and scope, as well as the benefits of competition. Because a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace, it allows the requesting carrier to produce efficiently and to compete effectively, which should drive retail prices to their competitive levels. We believe that our adoption of a forward-looking cost-based pricing methodology should facilitate competition on a reasonable and efficient basis by all firms in the industry by establishing prices for interconnection and unbundled elements based on costs similar to those incurred by the incumbents, which may be expected to reduce the regulatory burdens and economic impact of our decision for many parties, including both small entities seeking to enter the local exchange markets and small incumbent LECs.[1685]

680. We note that incumbent LECs have greater access to the cost information necessary to calculate the

---

[1685] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

incremental cost of the unbundled elements of the network. Given this asymmetric access to cost data, we find that incumbent LECs must prove to the state commission the nature and magnitude of any forward-looking cost that it seeks to recover in the prices of interconnection and unbundled network elements.

681. Some parties express concern that the information required to compute prices based on forward-looking costs is inherently so hypothetical as to be of little or no practical value.[1686] Based on the record before us, we disagree. A number of states, which ultimately will have to review forward- looking cost studies in carrying out their duties under section 252, either have already implemented forward-looking, incremental costing methodologies to set prices for interconnection and unbundled network elements or support the use of such an approach.[1687] While these states have applied somewhat different definitions of, and approaches to setting prices developed on, an incremental cost

---

[1686] *See, e.g.*, GVNW comments at 35; NYNEX comments at 54; USTA comments at 47-50.

[1687] *See, e.g.*, Louisiana Commission comments at 4; Texas Commission comments at 22; Washington Commission comments at 25; California Commission comments at 28-29; Colorado Commission comments at 35; Maryland Commission comments at 7-8; Oklahoma Commission comments at Attachment A (Oklahoma Corporation Commission Telephone Rules, OAC 165:55) pp. 10-11. The Wyoming and Florida commissions have indicated their support for such an approach. *See* Wyoming Commission comments at 27 (supporting uniform use of TSLRIC costing methods so long as details left to states); *see also* Florida Commission comments at 26 (TSLRIC may be appropriate to set cost standard for a price floor).

methodology, the record demonstrates that such approaches are practical and implementable.

682. We conclude that, under a TELRIC methodology, incumbent LECs' prices for interconnection and unbundled network elements shall recover the forward-looking costs directly attributable to the specified element, as well as a reasonable allocation of forward-looking common costs. Per-unit costs shall be derived from total costs using reasonably accurate "fill factors" (estimates of the proportion of a facility that will be "filled" with network usage); that is, the per-unit costs associated with a particular element must be derivedby dividing the total cost associated with the element by a reasonable projection of the actual total usage of the element. Directly attributable forward- looking costs include the incremental costs of facilities and operations that are dedicated to the element. Such costs typically include the investment costs and expenses related to primary plant used to provide that element. Directly attributable forward-looking costs also include the incremental costs of shared facilities and operations. Those costs shall be attributed to specific elements to the greatest extent possible.[1688] For example, the costs of conduits shared by both transport and local loops, and the costs of central office facilities shared by both local switching and tandem switching, shall be attributed to specific elements in reasonable proportions. More broadly, certain shared costs that have conventionally been treated as common costs (or overheads) shall be attributed directly to

---

[1688] *Compare Telephone Company-Cable Television Cross-Ownership Rules*, CC Docket No. 87-266, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 345-46 (1994).

the individual elements to the greatest extent possible. The forward-looking costs directly attributable to local loops, for example, shall include not only the cost of the installed copper wire and telephone poles but also the cost of payroll and other back office operations relating to the line technicians, in addition to other attributable costs.

683. Forward-looking cost methodologies, like TELRIC, are intended to consider the costs that a carrier would incur in the future. Thus, a question arises whether costs should be computed based on the least-cost, most efficient network configuration and technology currently available, or whether forward- looking cost should be computed based on incumbent LECs' existing network infrastructures, taking into account changes in depreciation and inflation. The record indicates three general approaches to this issue. Under the first approach, the forward-looking economic cost for interconnection and unbundled elements would be based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry. Prices based on the least-cost, most efficient network design and technology replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represent the least-cost systems available for purchase. This approach, however, may discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network.

684. Under the second approach, the cost of interconnection and unbundled network elements would be

based on existing network design and technology that are currently in operation.[1689] Because this approach is not based on a hypothetical network in the short run, incumbent LECs could recover costs based on their existing operations, and prices for interconnection and unbundled elements that reflect inefficient or obsolete network design and technology. This is essentially an embedded cost methodology.

685. Under the third approach, prices for interconnection and access to unbundled elements would be developed from a forward-looking economic cost methodology based on the most efficient technology deployed in the incumbent LEC's current wire center locations. This approach mitigates incumbent LECs' concerns that a forward-looking pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent thatnew entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC. We, therefore, conclude that the forward-looking pricing methodology for interconnection and unbundled network elements should be based on costs that assume that wire centers will be placed at the incumbent LEC's current wire center locations, but that the reconstructed local network will

---

[1689] *See, e.g.*, BellSouth reply at 37; Roseville Tel. reply at 8; USTA reply at 18-19.

employ the most efficient technology for reasonably foreseeable capacity requirements.

686. We agree with USTA, Bell Atlantic, and BellSouth that, as a theoretical matter, the combination of significant sunk investment, declining technology costs, and competitive entry may increase the depreciation costs and cost of capital of incumbent LECs. We do not agree, however, that TSLRIC does not or cannot account for risks that an incumbent LEC incurs because it has sunk investments in facilities. On the contrary, properly designed depreciation schedules should account for expected declines in the value of capital goods. Both AT&T and MCI appear to agree with this proposition.[1690] For example, AT&T states, "[i]n order to estimate TSLRIC, one must perform a discounted cash flow analysis of the future costs associated with the decision to invest .... One-time costs associated with the acquisition of capital goods are amortized over the economic life of the assets using the user cost of capital ..., which requires accounting for both expected capital good price changes and economic depreciation."[1691] Moreover, we are confident that parties to an arbitration with TELRIC

[1690] *See* Letter from Leonard S. Sawicki, Director, FCC Affairs, MCI Telecommunications Corp. to William F. Caton, Acting Secretary, FCC, July 24, 1996 at Attachment (Depreciation and Capital Recovery Issues: A Response to Professor Hausman), pp.1-3; *see also* Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman).

[1691] Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman), p.8.

studies can propose specific depreciation rate adjustments that reflect expected asset values over time.

687. As noted, we also agree that, as a matter of theory, an increase in risk due to entry into the market for local exchange service can increase a LEC's cost of capital. We believe that this increased risk can be partially mitigated, however, by offering term discounts, since long-term contracts can minimize the risk of stranded investment. In addition, growth in overall market demand can increase the potential of the incumbent LEC to use some of its displaced facilities for other purposes. Overall, we think that these factors can and should be captured in any LRIC model and therefore we do not agree that this requires a departure from the general principle of forward- looking cost-based pricing for network elements.

688. We are not persuaded by USTA's argument that forward looking methodologies fail to adjust the cost of capital to reflect the risks associated with irreversible investments and that they are "biased downward by a factor of three." First, USTA's argument unrealistically assumes that competitive entry would be instantaneous. The more reasonable assumption of entry occurring over time will reduce the costs associated with sunk investment. Second, we find it unlikely that investment in communications equipment is entirely irreversible or that such equipment would become valueless once facilities-based competition begins. In a growing market, there most likely would be demand for at least some embedded telecommunications equipment, which would therefore retain its value. Third, contractual arrangements between the new entrant and the incumbent that

specifically address USTA's concerns and protect incumbent's investments during transition can be established.

689. Finally we are not persuaded that the use by firms of hurdle rates that exceed the market cost of capital is convincing evidence that sunk investments significantly increase a firm's cost of capital. An alternative explanation for this phenomenon is that the process that firms use to choose among investment projects results in overestimates of their returns. Firms therefore use hurdle rates in excess of the market cost of capital to account for these overestimates.[1692]

690. *Summary of TELRIC Methodology.* The following summarizes our conclusions regarding setting prices of interconnection and access to unbundled network elements based on the TELRIC methodology for such elements. The increment that forms the basis for a TELRIC study shall be the entire quantity of the network element provided. As we have previously stated, all costs associated with the providing the element shall be included in the incremental cost. Only forward- looking, incremental costs shall be included in a TELRIC study. Costs must be based

---

[1692] *See* Richard Thaler, *The Winner's Curse*, 2 J. Econ. Perspectives 201 (1988); Keith Brown, *Note on the Apparent Bias of Net Revenue Estimates for Capital Investment Projects*, 29 J. Fin. 1215-16 (1974); Daniel Kahneman and Daniel Lovallo, *Timid Choices, Bold Forecasts*, 39 Management Science 17, 28 (1993). In addition, we note that Hausman's arguments that TSLRIC method underestimate the true cost of an element apply only to the capital expense associated with an element and not to the operating expense.

on the incumbent LEC's existing wire center locations and most efficient technology available.

691. Any function necessary to produce a network element must have an associated cost. The study must explain with specificity why and how specific functions are necessary to provide network elements and how the associated costs were developed. Only those costs that are incurred in the provision of the network elements in the long run shall be directly attributable to those elements. Costs must be attributed on a cost-causative basis. Costs are causally-related to the network element being provided if the costs are incurred as a direct result of providing the network elements, or can be avoided, in the long run, when the company ceases to provide them. Thus, for example, the forward-looking costs of capital (debt and equity) needed to support investments required to produce a given element shall be included in the forward-looking direct cost of that element. Directly attributable costs shall include costs such as certain administrative expenses, which have traditionally been viewed as common costs, if these costs vary with the provision of network elements. Retailing costs, such as marketing or consumer billing costs associated with retail services, are not attributable to the production of network elements that are offered to interconnecting carriers and must not be included in the forward-looking direct cost of an element.

692. In a TELRIC methodology, the "long run" used shall be a period long enough that all costs are treated as

variable and avoidable.[1693] This "long run" approach ensures that rates recover not only the operating costs that vary in the short run, but also fixed investment costs that, while not variable in the short term, are necessary inputs directly attributable to providing the element.

693. States may review a TELRIC economic cost study in the context of a particular arbitration proceeding, or they may conduct such studies in a rulemaking and apply the results in various arbitrations involving incumbent LECs. In the latter case, states must replace any interim rates[1694] set in arbitration proceedings with the permanent rate resulting from the separate rulemaking. This permanent rate will take effect at or about the time of the conclusion of the separate rulemaking and will apply from that time forward.

694. *Forward-Looking Common Costs.* Certain common costs are incurred in the provision of network elements. As discussed above, some of these costs are common to only a subset of the elements or services provided by incumbent LECs. Such costs shall be allocated to that subset, and should then be allocated among the individual elements or services in that subset, to the greatest possible extent. For example, shared maintenance facilities and vehicles should be allocated only to the elements that benefit from those facilities and vehicles. Common costs also include costs incurred by the firm's operations as a whole, that

---

[1693] *See* 1 Alfred E. Kahn *The Economics of Regulation: Principles and Institutions* 70-71 (1988).

[1694] *See infra*, Section VII.C., discussing default proxy price ceilings and ranges.

are common to all services and elements (*e.g.*, salaries of executives involved in overseeing all activities of the business), although for the purpose of pricing interconnection and access to unbundled elements, which are intermediate products offered to competing carriers, the relevant common costs do not include billing, marketing, and other costs attributable to the provision of retail service.[1695] Given these common costs, setting the price of each discrete network element based solely on the forward-looking incremental costs directly attributable to the production of individual elements will not recover the total forward-looking costs of operating the wholesale network.[1696] Because forward-looking common costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements.

695. The incumbent LECs generally argue that common costs are quite significant,[1697] while several other parties maintain that these amounts are minimal.[1698] Because the unbundled network elements correspond, to a great extent, to discrete network facilities, and have different operating

---

[1695] *See infra*, Section VIII.B., describing "avoided costs" in the resale context.

[1696] *See, e.g.*, AT&T comments at 61-66; Teleport comments at 47-48.

[1697] *See, e.g.*, PacTel reply at 27-28; *see also* Cincinnati Bell reply at 10; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), p.4 n.1.

[1698] *See, e.g.*, Competition Policy Institute comments at 19; MCI comments at 66; Texas Public Utility Counsel comments at 24.

characteristics, we expect that common costs should be smaller than the common costs associated with the long-run incremental cost of a service. We expect that many facility costs that may be common with respect to the individual services provided by the facilities can be directly attributed to the facilities when offered as unbundled network elements. Moreover, defining the network elements at a relatively high level of aggregation, as we have done,[1699] should also reduce the magnitude of the common costs. A properly conducted TELRIC methodology will attribute costs to specific elements to the greatest possible extent, which will reduce the common costs. Nevertheless, there will remain some common costs that must be allocated among network elements and interconnection services. For example, at the sub-element level of study (*e.g.*, identifying the respective costs of 2-wire loops, 4-wire loops, ISDN loops, and so on), common costs may be a significant proportion of all the costs that must be recovered from sub-elements. Given the likely asymmetry of information regarding network costs, we conclude that, in the arbitration process, incumbent LECs shall have the burden to prove the specific nature and magnitude of these forward-looking common costs.

696. We conclude that forward-looking common costs shall be allocated among elements and services in a reasonable manner, consistent with the pro- competitive goals of the 1996 Act. One reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs. We conclude that a second

---

[1699] *See supra*, Section V., discussing unbundling requirements.

reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as the local loop and collocation, that are most difficult for entrants to replicate promptly (*i.e.*, bottleneck facilities). Allocation of common costs on this basis ensures that the prices of network elements that are least likely to be subject to competition are not artificially inflated by a large allocation of common costs. On the other hand, certain other allocation methods would not be reasonable. For example, we conclude that an allocation methodology that relies exclusively on allocating common costs in inverse proportion to the sensitivity of demand for various network elements and services may not be used.[1700] We conclude that such an allocation could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the prices of, the most critical bottleneck inputs, the demand for which tends to be relatively inelastic. Such an allocation of these costs would undermine the pro-competitive objectives of the 1996 Act.

697. We believe that our treatment of forward-looking common costs will minimize regulatory burdens and economic impact for all parties involved in arbitration of agreements for interconnection and access to unbundled

---

[1700] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991). The sensitivity of demand is measured by the elasticity of demand, which is defined as the percentage change in the quantity of a service demanded for a one per cent change in price.

elements, and will advance the 1996 Act's pro-competitive objectives for local exchange and exchange access markets.[1701] In our decisionmaking, we have considered the economic impact of our rules in this section on small incumbent LECs. For example, although opposed to the use of a forward-looking, economic cost methodology, small incumbent LECs favor the recovery of joint and common costs in the event the Commission adopts forward-looking cost methodology. We are adopting such an approach. Moreover, the cost-based pricing methodology that we are adopting is designed to permit incumbent LECs to recover their economic costs of providing interconnection and unbundled elements, which may minimize the economic impact of our decisions on incumbent LECs, including small incumbent LECs. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1702]

698. We further conclude that, for the aggregate of all unbundled network elements, incumbent LECs must be given a reasonable opportunity to recover their forward-looking common costs attributable to operating the wholesale network. In no instance should prices exceed the stand-alone cost for a specific element, and in most cases they should be below stand-alone costs. Stand-alone costs are defined as the forward-looking cost that an efficient entrant would incur in

---

[1701] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1702] 47 U.S.C. § 251(f).

providing a given element or any combination of elements. No price higher than stand-alone cost could be sustained in a market from which entry barriers were completely absent. Where there are few common costs, there is likely to be only a minimal difference between the forward- looking costs that are directly attributable to the particular element, which excludes these costs, and stand-alone cost, which includes all of them. Network elements should not, however, be priced at levels that would enable the incumbent LEC to recover the same common costs multiple times from different elements. Any multiple recovery would be unreasonable and thus in violation of the statutory standard. Further, we note that the sum of the direct costs and the forward-looking common costs of all elements will likely differ from the incumbent LEC's historical, fully distributed costs.

699. *Reasonable Return on Investment and "Profit."* Section 252(d)(1) states that rates for interconnection and access to unbundled elements "may include a reasonable profit."[1703] We find that the TELRIC pricing methodology we are adopting provides for such a reasonable profit and thus no additional profit is justified under the statutory language. We note there are two types of profit. First, in plain English, profit is defined as "the excess of returns over expenditure in a transaction or a series of transactions."[1704] This is also known as a "normal" profit, which is the total revenue required to cover all of the costs of a firm, including its

---

[1703] 47 U.S.C. § 252(d)(1).

[1704] *Webster's New Collegiate Dictionary* 931 (10th ed. 1994).

opportunity costs.[1705] Second, there is "economic" profit, which is any return in excess of normal profit.[1706] Thus, for example, if the normal return in an industry is 10 percent and a firm earns a return of 14 percent, the economic profit for that firm is 4 percent. Economic is also referred to as "supranormal" profit. We conclude that the definition of "normal" profit is embodied in "reasonable profit" under Section 252(d)(1).

700. The concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements. This forward-looking cost of capital is equal to a normal profit. We conclude that allowing greater than normal profits would not be "reasonable" under sections 251(c) and 252(d)(1).[1707] Thus, contrary to the arguments put forth by

---

[1705] *See* David W. Pearce, *The MIT Dictionary of Modern Economics* (1994) at 310.

[1706] *Id.* at 415.

[1707] We note that our interpretation is consistent with existing Supreme Court precedent concerning what constitutes a reasonable rate of return for a regulated public utility. For example, in *Bluefield Water Works*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.

several incumbent LECs, we find that adding an additional measure of profit to the risk-adjusted cost of capital[1708] in setting the prices for interconnection and access to unbundled elements would violate the requirements of sections 251(c) and 252(d)(1) of the 1996 Act.

701. Possible accounting losses from the sale of interconnection and unbundled network elements using a reasonable forward-looking cost-based methodology do not necessarily indicate that incumbent LECs are being denied a "reasonable profit" under the statute. The use of a forward-looking, economic, cost-based pricing methodology, including a reasonable allocation of legitimate joint and common costs, will permit incumbent LECs the opportunity

---

Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923). Similarly, in *FPC v. Hope Natural Gas*, the Court stated:

> ... it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock ...By that standard the return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1994) *(Hope Natural Gas). Cf.*, Charles F. Phillips, Jr., *The Economics of Regulation* 260 (Rev. Ed. 1965)("...a regulated company must be afforded the opportunity not only of assuring its financial integrity so that it can maintain its credit standing and attract additional capital as needed, but also for earnings comparable to those of other companies having corresponding risks.")

[1708] *See supra*, this Section, for a discussion of risk-adjusted cost of capital.

to earn a reasonable return on their investment in network elements. Finally, contrary to PacTel's argument, and as discussed below in detail, we conclude that our forward-looking cost-based pricing methodology is consistent with the Fifth Amendment and is not confiscatory.

702. Based on the current record, we conclude that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk- adjusted cost of capital or depreciation rate. These elements generally are bottleneck, monopoly services that do not now face significant competition. We recognize that incumbent LECs are likely to face increased risks given the overall increases in competition in this industry, which generally might warrant an increased cost of capital, but note that, earlier this year, we instituted a preliminary inquiry as to whether the currently authorized federal 11.25 percent rate of return is too high given the current marketplace cost of equity and debt.[1709] On the basis of the current record, we decline to engage in a time-consuming examination to determine a new rate of return, which may well require a detailed proceeding. States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted, without that commission conducting a

---

[1709] *See Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry*, Public Notice, 11 FCC Rcd 3651 (Com. Car. Bur. 1996).

"rate-of-return or other rate based proceeding."[1710] We note that the risk-adjusted cost of capital need not be uniform for all elements. We intend to re-examine the issue of the appropriate risk-adjusted cost of capital on an ongoing basis, particularly in light of the state commissions' experiences in addressing this issue in specific situations.

703. We disagree with the conclusion that, when there are mostly sunk costs, forward-looking economic costs should not be the basis for pricing interconnection elements. The TELRIC of an element has three components, the operating expenses, the depreciation cost,[1711] and the appropriate risk- adjusted cost of capital. We conclude that an appropriate calculationof TELRIC will include a depreciation rate that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor. Thus, even in the presence of sunk costs, TELRIC-based prices are an appropriate pricing methodology.

(b) Cost Measures Not Included in Forward-Looking Cost Methodology

704. *Embedded Costs.* We read section 252(d)(1)(A)(i) to prohibit states from conducting traditional rate-of-return or other rate-based proceedings to determine

---

[1710] 47 U.S.C. § 252(d)(1)(A)(i).

[1711] Depreciation is the method of recognizing as an expense the cost of a capital investment. Properly calculated economic depreciation is a periodic reduction in the book value of an asset that makes the book value equal to its economic or market value.

rates for interconnection and access to unbundled network elements. We find that the parenthetical, "(determined without reference to a rate-of- return or other rate-based proceeding),"[1712] does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the cost of interconnection and unbundled network elements. The legislative history demonstrates that Congress was eager to set in motion expeditiously the development of local competition and intended to avoid imposing the costs and administrative burdens associated with a traditional rate case. Prior to the joint conference, the Senate version of the 1996 Act contained the parenthetical language.[1713] In addition, the Senate version of the 1996 Act eliminated rate-of-return regulation,[1714] as did the House version.[1715] Conferees

---

[1712] 47 U.S.C. § 252(d)(1)(A)(i).

[1713] S. 652, 104th Cong., 1st Sess. s 251(d)(6)(A) (1995) ("the charge (A) shall be (i) based on the cost (determined without reference to a rate-of- return or other rate-based proceeding) of providing the unbundled element ....").

[1714] *Id.* at s 301(a)(3) ("Rate of Return Regulation Eliminated -- (A) In instituting the price flexibility required under paragraph (1) the Commission and the States shall establish alternative forms of regulation for Tier 1 telecommunications carriers that do not include regulation of the rate of return earned by such carrier....").

[1715] H.R. 1555, 104th Cong., 1st Sess. s 248(b) (1995) ("Abolition of Rate- of-Return Regulation -- Notwithstanding any other provision of law, to the extent that a carrier has complied with sections 242 and 244 of this part, the Commission, with respect to rates for interstate or foreign communications, and State commissions, with respect to rates for intrastate communications, shall not require rate-of-return regulation.").

removed the provisions eliminating rate-of-return regulation, but retained the parenthetical.

705. Section 252(d)(1)(A)(i) does not specify whether historical or embedded costs should be considered or whether only forward-looking costs should be considered in setting arbitrated rates. We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes the prices for interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a price based on forward looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an "embedded cost"-based pricing methodology would be pro-competitor -- in this case the incumbent LEC -- rather than pro-competition.[1716] We therefore decline to adopt embedded costs as the appropriate basis of setting prices for interconnection and access to unbundled elements. Rather, we reiterate that the prices for the interconnection and

---

[1716] *See, e.g.*, Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p.4; ALTS comments at Attachment B (Competitive Pricing of Interconnection, Unbundled Elements, and Collocation), pp.28-29; AT&T reply at Appendix B (Reply Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.3-5; Competition Policy Institute comments at 18-19; DJ comments at 30-31.

network elements critical to the development of a competitive local exchange should be based on the pro- competition, forward-looking, economic costs of those elements, which may be higher or lower than historical embedded costs. Such pricing policies will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act, which should minimize the regulatory burdens and economic impact of our decisions on small entities.[1717]

706. Incumbent LECs contend generally that, in order to ensure they will recover their total investment costs and earn a profit, they must recover embedded costs. These costs, they argue, were incurred under federal and regulatory oversight and therefore should be recoverable.[1718] We are not convinced by the incumbent LECs' principal arguments for recognizing embedded cost in setting section 251 pricing rules. Even if the incumbent LECs' contention is correct, increasing the rates for interconnection and unbundled elements offered to competitors would interfere with the development of efficient competition, and is not the proper remedy for any past under- depreciation. Moreover, contrary to assertions bysome incumbent LECs, regulation does not and should not guarantee full recovery of their embedded costs. Such a guarantee would exceed the assurances that we or the states have provided in the past.[1719] We have

[1717] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1718] *See, e.g.*, Ameritech reply at 31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

[1719] *See In the Matter of the Applications of Pacific Bell*, Order and Authorization, 10 FCC Rcd 12448, 12502-12503 (1995).

considered the economic impact of precluding recovery of small incumbent LECs' embedded costs.[1720] We do not believe that basing the prices of interconnection and unbundled elements on an incumbent LEC's embedded costs would advance the pro-competitive goals of the statute. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1721]

707. We acknowledge that some incumbent LECs may have incurred certain embedded costs reasonably before the passage of the 1996 Act, based on different regulatory regimes. Some incumbent LECs may assert that they have made certain historical investments required by regulators that they have been denied a reasonable opportunity to recover in the past and that the incumbent LECs may no longer have a reasonable opportunity to recover in the new environment of the 1996 Act. The record before us, however, does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at economic costs. To the extent that any such residual consists of costs of meeting universal service obligations, the recovery of such costs can and should be considered in our ongoing universal service proceeding.[1722]

[1720] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1721] 47 U.S.C. § 251(f).

[1722] *See Universal Service* NPRM at para. 32.

To the extent a significant residual exists within the interstate jurisdiction that does not fall within the ambit of section 254, we intend that to address that issue in our upcoming proceeding on access reform.

708. *Opportunity Cost -- Efficient Component Pricing Rule*. A number of incumbent LECs advocate using the "efficient component pricing rule" (ECPR) to set the prices that incumbent LECs charge new entrants for inputs required to produce the same retail services the incumbent produces. Under the ECPR, the price of an input should be equal to the incremental cost of the input plus the opportunity cost that the incumbent carrier incurs when the new entrant provides the services instead of the incumbent. The opportunity cost, which is computed as revenues less all incremental costs, represents both profit and contribution to common costs of the incumbent, given the existing retail prices of the services being sold.

709. We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based. Moreover, the ECPR does not provide any mechanism for moving prices towards competitive levels; it simply takes prices as given. The record indicates that both incumbents and new entrants agree that retail prices are not based on costs. Incumbents generally argue that local residential retail prices are below costs while new entrants contend that they exceed competitive levels.[1723]

[1723] *See, e.g.*, Ameritech comments at 62.

In either case, application of ECPR would result in input prices that would be either higher or lower than those which would be generated in a competitive market and would not lead to efficient retail pricing.

710. In markets where retail prices exceed competitive levels, entry would take place if network element prices were set at efficient competitive levels. The ECPR, however, will serve to discourage competition in these very markets because it relies on the prevailing retail price in setting the price which new entrants pay the incumbent for inputs. While ECPR establishes conditions for efficient entry given existing retail prices, as its advocates contend, the ECPR provides no mechanism that will force retail prices to their competitive levels. We do not believe that Congress envisioned a pricing methodology for interconnection and network elelments that would insulate incumbent LECs' retail prices from competition. Instead, Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore, we reject the use of ECPR for establishing prices for interconnection and unbundled elements.

711. As discussed above, the record in this docket shows that end user prices are not cost-based. In *Open Video Systems*, in contrast, we did not find that there would be a problem with the determination of end user prices.[1724] We concluded that "[u]se of [an ECPR] approach is appropriate in circumstances where the pricing is applicable [sic] to a new

---

[1724] *Implementation of Section 302 of the Telecommunications Act of 1996 -- Open Video Systems*, CS Docket No. 96-46, Second Report and Order, FCC 96-249 (rel. June 3, 1996) *(Open Video Systems)*.

market entrant (the open video system operator) that will face competition from an existing incumbent provider (the incumbent cable operator), as opposed to circumstances where the pricing is used to establish a rate for an essential input service that is charged to a competing new entrant by an incumbent provider."[1725] In addition, in *Open Video Systems*, we concluded that the ECPR is appropriate because it encourages entry for open video system operators and also enhances the availability of carriage for unaffiliated programmers.[1726] The ECPR generally protects the provider's profits and provides opportunities for third parties to use the provider's inputs. The ECPR does not provide a mechanism to drive retail prices to competitive levels, however. In *Open Video Systems*, we wanted to encourage entry by open video system providers and to encourage them to have incentives to open their systems to unaffiliated programmers. Here, our goal is to ensure that competition between providers, including third party providers using interconnection and unbundled elements, will drive prices toward competitive levels and thus use of the ECPR is inappropriate.

712. *Universal Service Subsidies*. We conclude that funding for any universal service mechanisms adopted in the universal service proceeding may not be included in the rates for interconnection, network elements, and access to network elements that are arbitrated by the states under sections 251 and 252. Sections 254(d) and 254(e) of the 1996 Act mandate that universal service support be recovered in an equitable and nondiscriminatory manner from all providers of

---

[1725] Id at 127.

[1726] *Id.*

telecommunications services.[1727] We conclude that permitting states to include such costs in rates arbitrated under sections 251 and 252 would violate that requirement by requiring carriers to pay specified portions of such costs solely because they are purchasing services and elements under section 251. Section 252(d)(1) requires that rates for interconnection, network elements, and access to network elements reflect the costs of providing those network elements, not the costs of supporting universal service.

713. Section 254(f) provides that a state may adopt equitable, nondiscriminatory, specific, and predictable mechanisms to advance universal service within that state.[1728] If a state collects universal service funding in rates for elements and services pursuant to sections 251 and 252, it will be imposing non-cost based charges in those rates. Including non-cost based charges in the rates for interconnection and unbundled elements is inconsistent with our rules implementing sections 251 and 252 which require that these rates be cost-based. It is also inconsistent with the requirement of section 254(f) that telecommunications carriers contribute to state universal service on a nondiscriminatory basis, because telecommunications carriers requesting interconnection or access to unbundled network elements will be required to make contributions to universal

---

[1727] Joint Explanatory Statement at 131 ("In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit ...").

[1728] 47 U.S.C. § 254(f).

service support through such surcharges.[1729] States may not, therefore, include universal service support funding in the rates for elements and services pursuant to sections 251 and 252, nor may they implement mechanisms that have the same effect. For example, states may not fund universal service support by imposing higher rates for interconnection, unbundled elements, or transport and termination on carriers that offer service to different types of customers or different geographic areas. To the extent that New York's "pay or play" system funds universal service in this manner, it violates sections 251, 252, and 254 of the 1996 Act. Nothing in the 1996 Act or in this Order, however, precludes a state from adopting a universal service funding mechanism, whether interim or otherwise, if such funds are collected in accordance with section 254(f) on an "equitable and nondiscriminatory basis" through "specific, predictable, and sufficient mechanisms that do not rely on or burden Federal universal service support mechanisms."[1730]

714. Our decision here does not exempt carriers purchasing elements or services under section 251 from contributing to (or possibly receiving) universal service support. Rather, the recovery of universal service support costs from telecommunications carriers, including carriers requesting unbundled network elements, will be governed by section 254 of the 1996 Act. Federal universal service support mechanisms will be determined by our decisions reached in CC Docket 96-45, based on the recommendations of the Federal/State Universal Service Joint Board, and states

---

[1729] *See infra*, Section VII.D.3., discussing discrimination.

[1730] 47 U.S.C. § 254(f).

may adopt additional universal service support mechanisms consistent with section 254(f).

715. We are mindful that the requirements of the 1996 Act may be disruptive to existing state universal service support mechanisms during the period commencing with this order and continuing until we complete our universal service proceeding to implement section 254. As discussed in the subsection immediately below, we permit incumbent LECs to continue to recover certain non- cost-based interstate access charge revenues for a limited period of time, largely because of concerns about possible deleterious impacts on universal service. We also authorize incumbent LECs, for a similar limited period of time, to continue to recover explicit intrastate universal service subsidy revenues based on intrastate access charges. This mechanism minimizes any possibility that implementation of sections 251 and 252 will unduly harm universal service during the interim period prior to completion of our universal service and access reform proceedings. Because we conclude this action should adequately provide for the continuation of a portion of existing subsidy flows during a transition period until completion of our proceeding implementing section 254, we decline to permit any additional funding of universal service support through rates for interconnection, unbundled elements, and transport and termination during the interim period.

716. *Interim Application of Access Charges to Purchasers of Unbundled Local Switching Element.* In the introduction of this Order, we emphasize that implementation of section 251 of the 1996 Act is integrally related to both universal service reform as required under section 254, and to

reform of the interstate access charge system.[1731] In order to achieve pro-competitive, deregulatory markets for all telecommunications services, we must create a new system of funding universal service that is specific, explicit, predictable, sufficient, and competitively neutral. We also must move access charges to more cost-based and economically efficient levels. We intend to fulfill both of these goals in the coming months, by completing our pending universal service proceeding to implement section 254 by our statutory deadline of May 1997, and by addressing access charge issues in an upcoming access reform proceeding. The 1996 Act, however, requires us to adopt rules implementing section 251 by August 1996. We are concerned that implementation of the requirements of section 251 now, without taking into account the effects of the new rules on our existing access charge and universal service regimes, may have significant, immediate, adverse effects that were neither intended nor foreseen by Congress.

717. Specifically, as we conclude above, the 1996 Act permits telecommunications carriers that purchase access to unbundled network elements from incumbent LECs to use those elements to provide telecommunications services, including the origination and termination of interstate calls. Without further action on our part, section 251 would allow entrants to use those unbundled network facilities to provide access services to customers they win from incumbent LECs, without having to pay access charges to the incumbent LECs. This result would be consistent with the long term outcome in a competitive market. In the short term, however, while

---

[1731] *See supra*, Section I.B.

other aspects of our regulatory regime are in the process of being reformed, such a change may have detrimental consequences.

718. The access charge system includes non-cost-based components and elements that at least in part may represent subsidies, such as the carrier common line charge (CCLC) and the transport interconnection charge (TIC). The CCLC recovers part of the allocated interstate costs for incumbent LECs to provide local loops to end users. In the universal service NPRM, we observed that the CCLC may result in higher-volume toll users paying rates that exceed cost, and some customers paying rates that are below cost. We sought comment on whether that subsidy should be continued, and on whether and how it should be restructured.[1732] The nature of most of the revenues recovered through the TIC is unclear and subject to dispute, although a portion of the TIC is associated with certain costs related to particular transport facilities. Although the TIC was not created to subsidize local rates, some parties have argued in the *Transport* proceeding and elsewhere that some portion of the revenues now recovered through the TIC may be misallocated local loop or intrastate costs that operate to support universal service.[1733] In the forthcoming access

---

[1732] *Universal Service* NPRM at paras. 113-14.

[1733] *Transport Rate Structure and Pricing*, CC Docket No. 91-213, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7065-7066 (1992) *(First Transport Order)*. *Cf.* Letter from Bruce K. Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, September 7, 1995 (filed in CC Docket No. 91-213) (suggesting that TIC revenues not allocable to specific transport facilities may represent misallocated common line costs).

reform proceeding, we intend to consider the appropriate disposition of the TIC, including the development of cost-based transport rates as directed by the United States Court of Appeals for the District of Columbia Circuit in *Competitive Telecommunications Association v. FCC* (*CompTel v. FCC*).[1734]

719. Without a temporary mechanism such as the one we adopt below, the implementation of section 251 would permit competitive local service providers that also provide interstate long-distance service to avoid totally the CCLC and the TIC, which in part represent contributions toward universal service, by serving their local customers solely through the use of unbundled network elements rather than through resale. We believe that allowing such a result before we have reformed our universal service and access charge regimes would be undesirable as a matter of both economics and policy, because carrier decisions about how to interconnect with incumbent LECs would be driven by regulatory distortions in our access charge rules and our universal service scheme, rather than the unfettered operation of a competitive market. Because of our desire to err on the side of caution where universal service may be implicated, we conclude that some action is needed during the interim period before we complete our access reform and universal service proceedings.

720. We conclude that we should establish a temporary transitional mechanism to help complete all of the steps toward the pro-competitive goal of the 1996 Act,

---

[1734] *Competitive Telecommunications Association v. FCC*, No. 96-1168 (D.C. Cir. July 5, 1996).

including the implementation of a new, competitively-neutral system to fund universal service and a comprehensive review of our system of interstate access charges. Therefore, for a limited period of time, incumbent LECs may recover from interconnecting carriers the CCLC and a charge equal to 75 percent of the TIC for all interstate minutes traversing the incumbent LECs' local switches for which the interconnecting carriers pay unbundled local switching element charges. Incumbent LECs may recover these charges only until the earliest of: (1) June 30, 1997; (2) the effective date of final decisions by the Commission in both the universal service and access reform proceedings; or (3) if the incumbent LEC is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. The end date for BOCs that are authorized to offer interLATA service shall apply only to the recovery of access charges in those states in which the BOC is authorized to offer such service.

721. We tentatively concluded in the NPRM that purchasers of unbundled network elements should not be required to pay access charges. We reaffirm our conclusion above in our discussion of unbundled network elements that nothing on the face of sections 251(c)(3) and 252(d)(1) compels telecommunications carriers that use unbundled elements to pay these charges, nor limits these carriers' ability to use unbundled elements to originate or terminate interstate calls, and that payment of rates based on TELRIC plus a reasonable allocation of common costs, pursuant to section 251(d)(1), represents full compensation to the incumbent LEC for use of the network elements that telecommunications carriers purchase. Because of the unique situation described in the preceding paragraphs, however, we conclude, contrary to

our proposal in the NPRM, that during a time-limited period, interconnecting carriers should not be able to use unbundled elements to avoid access charges in all cases. As detailed below, this temporary mechanism will apply only to carriers that purchase the local switch as an unbundled network element, and use that element to originate or terminate interstate traffic.[1735] We are applying these transitional charges to the unbundled local switching element, rather than to any other network elements, because such an approach is most closely analogous to the manner in which the CCLC and TIC are recovered in the interstate access regime. Currently, the CCLC and TIC apply to interstate switched access minutes that traverse incumbent LECs' local switches. Applying the CCLC and 75 percent of the TIC to the unbundled local switching element is consistent with our goal of minimizing disruptions while we reform our universal service system and consider changes to our access charge mechanisms. Moreover, the CCLC and the TIC are recovered on a per-minute basis, and the local switch is the primary point at which incumbent LECs are capable of recording interstate minutes for traffic associated with end user customers of requesting carriers.

722. We have crafted this short-term continuation of certain access charge revenue flows to minimize the possibility that incumbent LECs will be able to "double recover" through access charges the facility costs that new

---

[1735] As discussed *infra*, carriers that choose to enter a local market through resale of an incumbent LEC's intrastate local exchange service will pay interstate and intrastate access charges to originate and terminate toll traffic for end user customers that purchase that resold local exchange service.

entrants have already paid to purchase unbundled elements. For that reason, we do not permit incumbent LECs to assess on purchasers of the unbundled local switching element any interstate access charges other than the CCLC and 75 percent of the TIC. The other access charges are all designed to recover the cost of particular facilities involved in the provision of interstate access services, such as local switching, dedicated interoffice transport circuits, and tandem switching. Imposition of these facility-based access charges in addition to the cost-based charges for comparable network elements established under Section 252 could result in double recovery. The mechanism we establish will ensure that incentives created by non-cost-based elements of access charges do not result in harmful consequences prior to completion of access reform and our universal service proceeding. Imposition of additional access charges is therefore not necessary. We note that this mechanism serves to minimize the potentially disruptive effects of our decisions on incumbent LECs, including small incumbent LECs.[1736]

723. For the same reason, we permit incumbent LECs to recover only 75 percent of the TIC. Some portion of the TIC recovers revenues associated with specific transport facilities. To the extent that these costs can be identified clearly, they should not be imposed on new entrants through the TIC. Incumbent LECs will be fully compensated for any transport facilities that new entrants purchase from them through the unbundled element rates states establish under 252(d)(1), which, as we have stated, must be based on economic cost rather than access charges. In our interim

---

[1736] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

transport rate restructuring, we explicitly set the initial tandem switching rate at 20 percent of the interstate revenue requirement, with the remainder included in the TIC.[1737] In addition, certain costs of upgrading incumbent LEC networks to support SS7 signaling were allocated to transport through then-existing separations procedures. In our interim transport rate restructuring, we did not create any facility-based charges to recover these costs,[1738] so the associated revenues presumably were incorporated into the TIC. There may also be other revenues associated with transport facilities that are recovered today through the TIC. While we are uncertain of the precise magnitude of these revenues, in our best judgment, based on the record in the *Transport* proceeding and other information before us, we find that it is likely that these revenues approach, but probably do not exceed 25 percent of the TIC for most incumbent LECs. Thus, we believe that 25 percent is a conservative amount to exclude from the TIC to ensure that incumbent LECs do not double recover revenues associated with transport facilities from new entrants. Moreover, the Court in *CompTel v. FCC* remanded our *Transport* decision, in part, because of the inclusion of tandem switching revenues in the TIC rather than in the rate element for tandem switching. We find that excluding 25 percent of the TIC represents a reasonable exercise of our discretion to prevent revenues associated with the tandem switching revenue requirement from being recovered from purchasers or unbundled local switching.

[1737] *First Transport Order*, 7 FCC Rcd at 7019.

[1738] *First Transport Order*, 7 FCC Rcd at 7019.

724. We strongly emphasize that these charges will apply to purchasers of the unbundled switching element only for a very limited period, to avoid the possible harms that might arise if we were to ignore the effects on access charges and universal service of implementation of section 251. BOCs shall not be permitted to recover these revenues once they are authorized to offer in- region interLATA service, because at that time the potential loss of access charge revenues faced by a BOC most likely will be able to be offset by new revenues from interLATA services. Moreover, although we do not prejudge the conditions necessary to grant BOC petitions under section 271 to offer in- region interLATA service, we do decide that BOCs should not be able to charge the CCLC and the TIC, which are not based on forward-looking economic costs, to competitors that use unbundled elements under section 251 once they are authorized to provide in-region interLATA service. Only BOCs are subject to special restrictions in the 1996 Act to ensure that their entry into the in- region interLATA market does not have an adverse impact on competition. We conclude that this additional trigger date after which BOCs may not continue to receive access charges from purchasers of unbundled local switching is consistent with this Congressional design.

725. We have selected June 30, 1997 as an ultimate end date for this transitional mechanism to coincide with the effective date for LEC annual access tariffs, and because we believe it is imperative that this transitional requirement be limited in duration. We can conceive of no circumstances under which the requirement that certain entrants pay the CCLC or a portion of the TIC on calls carried over unbundled network elements would be extended further. The fact that

access or universal service reform have not been completed by that date would not be a sufficient justification, nor would any actual or asserted harm to the financial status of the incumbent LECs. By June 30, 1997, the industry will have had sufficient time to plan for and adjust to potential revenue shifts that may result from competitive entry. Thus, the economic impact of our decision on competitive local service providers, including those that are small entities, should be minimized.[1739]

726. We believe that we have ample legal authority to implement this temporary transitional measure, and we find that this approach is consistent with the letter and spirit of the 1996 Act. We recognize that the CCLC and TIC have not been developed in accordance with the pricing standards of section 252(d)(1), and that to comply with the 1996 Act, the rates that states establish for interconnection and unbundled network elements may not include non-cost-based amounts or subsidies. The 1934 and 1996 Acts do, however, give us legal authority to determine, for policy reasons, that users of LEC facilities should pay certain access charges for a period of time.[1740] Section 4(i) of the 1934 Act authorizes the Commission to "perform any and all acts ... not inconsistent with this Act, as may be necessary in the execution of its

---

[1739] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1740] *See, e.g., New England Tel. and Tel. Co. v. FCC,* 826 F.2d 1101 (D.C. Cir 1987); *North American Telecommunications Association v. FCC,* 772 F.2d (7th Cir. 1085); *Lincoln Tel. and Tel. Co. v. FCC,* 659 F.2d (D.C. Cir. 1989).

functions."[1741] Given the extraordinary upheaval in the industry's structure set in motion by the 1996 Act, and the specific concerns described above, we believe that a temporary mechanism is necessary in order to ensure that the policy goals underlying the access charge system and the Communications Act itself are not undermined. Further, we believe section 251(g) of the 1996 Act lends support to our decision. As discussed above, section 251(g) does not require that incumbent LECs continue to receive access charge revenues when telecommunications carriers use unbundled incumbent LEC network elements to originate and terminate interstate traffic. That section does, however, provide evidence of Congressional recognition of the potential tension between existing interconnection obligations, such as access charges, and the new methods of interconnection mandated by section 251, and therefore supports our decision to create a limited-duration mechanism to address this tension.

727. The decision of the court in *CompTel v. FCC* to remand our decision to adopt the TIC is not inconsistent with this approach. The Court's concern stemmed, in part, from the inclusion of a portion of the interstate tandem switching revenue requirement in the TIC. We have excluded from the charges that purchasers of unbundled local switching must pay a percentage of the TIC that, at a minimum, includes these allocated tandem switching revenues from the transitional charges that incumbent LECs may assess on IXCs.[1742] Furthermore, the Court directed the Commission to

---

[1741] 47 U.S.C. § 4(i).

[1742] As discussed above, we estimate that the tandem switching, SS7, and other costs associated with transport facilities now recovered

develop a cost-based transport rate structure, or to explain why it chose not to do so.[1743] We intend to fulfill this obligation in the forthcoming access reform proceeding. The charge equal to 75 percent of the TIC will be applied only as an interim measure for a brief, clearly-identified period, until that restructuring of access charges is completed. The court expressly acknowledged that the 1996 Act would have implications for the access charge system.[1744] For the reasons described above, we conclude that these effects necessitate temporary application of a portion of the TIC to entrants that win end user customers from LECs, and that purchase the local switch as an unbundled element to originate and terminate interstate and intrastate toll traffic for such end users. In the access reform proceeding, we intend to determine the appropriate disposition for these revenues. Until we have had the opportunity to do so, however, we permit incumbent LECs to recover a transitional charge equal to 75 percent of the TIC under the limited circumstances described herein.

728. The interim mechanism we establish here differs from the waiver relief we have previously granted to NYNEX and Ameritech to permit them to recover certain interstate access charge revenues through "bulk billing" of

---

through the TIC likely do not exceed 25% of the TIC for most incumbent LECs.

[1743] *Competitive Telecommunications Association v. FCC*, No. 96-1168 at 26- 27.

[1744] Id at 12-13.

revenues to all interstate switched access customers.[1745] Those orders responded to waiver requests filed prior to the passage of the 1996 Act. Our responsibility in those proceedings was to determine whether special circumstances existed, and whether the specific relief requested better served the public interest than continued application of our general rules. By contrast, the action we take today addresses industry-wide issues that arise from the new regime put into place by section 251 of the 1996 Act, which allows states to establish unbundled network element rates that recover the full unseparated cost of elements. Our response to the Ameritech and NYNEX waiver petitions does not, simply because those petitions also concerned access charge recovery, constrain our decision in this proceeding.

729. It would be unreasonable to provide such a transitional mechanism on the federal level, but to deny similar authority to the states. Therefore, states may continue existing explicit universal service support mechanisms based on intrastate access charges for an interim period of a similar brief, clearly- defined length. During that period, unless decided otherwise by the state, incumbent LECs may continue to recover such revenues from purchasers of unbundled local switching elements that use those elements to originate or terminate intrastate toll calls for end user customers they win

---

[1745] *See The NYNEX Tel. Cos. Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment*, Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995), *reconsideration pending (NYNEX USPP Order); Ameritech Operating Companies Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region*, Order, FCC 96-58 (released Feb. 15, 1996) *(Ameritech Customers First Order)*.

from incumbent LECs. States may terminate these mechanisms at any time. We define mechanisms based on intrastate access charges as those mechanisms that require purchasers of intrastate access services from incumbent LECs to pay non-cost-based charges for those access services on the basis of their intrastate access minutes of use.

730. We do not intend, however, that such a transitional mechanism eviscerate the requirements of sections 252 and 254, which, as we have stated, prohibit funding of universal service subsidies through rates for interconnection and unbundled network elements. Mechanisms such as New York's "pay or play" system, which would impose intrastate access charges on non-access services rather than allowing incumbent LECs to recover non-cost-based revenues from purchasers of access services, may not be included in this interim system. Such a result is justified because state "pay or play" mechanisms do not at present constitute a significant revenue stream to incumbent LECs, and therefore elimination of this mechanism is unlikely, in the short term, to have significant detrimental effects on universal service support.

731. These state mechanisms must end on the earlier of: (1) June 30, 1997; or (2) if the incumbent LEC that receives the transitional access charge revenues is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. With one exception, the analysis provided above as to the rationale for the end dates for the transitional interstate access charge mechanism applies here as well. Because our access reform proceeding focuses on federal charges, and because the full extent of the section 254 universal service mechanism

remains to be determined in that proceeding, intrastate access charge-based universal service support mechanisms should not now be required to terminate upon the completion of those proceedings.

732. As with our decision to permit incumbent LECs to continue to receive certain interstate access charge revenues from some purchasers of unbundled local switching for a limited period of time, we believe our decision to allow states to preserve certain intrastate universal service support mechanisms based on access charges is within our authority under section 251(d)(1) of the 1996 Act, and section 4(i) of the 1934 Act. Moreover, although section 251(g) does not directly refer to intrastate access charge mechanisms, it would be incongruous to conclude that Congress was concerned about the effects of potential disruption to the interstate access charge system, but had no such concerns about the effects on analogous intrastate mechanisms.

(c) Fifth Amendment Issues

733. We conclude that our decision that prices for incumbent LECs' unbundled elements and interconnection offerings be based on forward-looking economic cost does not violate the incumbent LECs' rights under the Fifth Amendment of the Constitution. The Supreme Court has recognized that public utilities owned and operated by private investors, even though their assets are employed in the public interest to provide consumers with service, may assert their rights under the Takings Clause of the Fifth Amendment.[1746]

[1746] The Fifth Amendment provides that, "private property [shall not] be taken for public use, without just compensation." U.S. Const. amend. V.

In applying the Takings Clause to rate setting for public utilities, the Court has stated that "[t]he guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory."[1747]

734. The Supreme Court has held that the determination of whether a rate is confiscatory depends on whether that rate is just and reasonable, and not on what methodology is used.[1748] In *Federal Power Comm'n v. Hope Natural Gas Co.*, the Court upheld the Federal Power Commission's order that required the company to make a large reduction in wholesale gas rates. The commission based its determination of a reasonable rate of return on a plant valuation determined by using a historical cost methodology that was only half as large as the company's own valuation based on forward-looking reproduction costs. In its decision, the Court set forth the governing legal standard for determining whether a rate is constitutional:

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed that is

---

See Duquesne Light Co. v. Barasch, 488 U.S. 299, 307 (1989) *(Duquesne)*.

[1747] *Duquesne*, 488 U.S. at 307 *(citing Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896)).

[1748] *Hope Natural Gas*, 320 U.S. at 602-603; *see also Duquesne; In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); *Jersey Central Power & Light v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987).

> controlling. It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[1749]

735. The Court went on to explain that, in determining whether a rate is reasonable, the regulatory body must balance the interests of both the investor and consumer.[1750] "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business .... [T]he return on the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[1751]

736. Under sections 251(c)(2) and (3) of the 1996 Act, incumbent LECs must establish rates for interconnection and unbundled elements that are just and reasonable.[1752] In adopting the rules that govern those rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We

---

[1749] *Hope Natural Gas*, 320 U.S. at 602.

[1750] *Id.*

[1751] *Id.* at 603.

[1752] 47 U.S.C. § 251(c)(2) and (3).

disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed.[1753] Indeed, the Court has found that the "fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid."[1754] Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred.[1755] Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.

737. Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, including the revenues for other services under our jurisdiction.[1756]

[1753] *See, e.g., Duquesne,* 488 U.S. at 310; *Hope Natural Gas,* 320 U.S. at 602.

[1754] *Hope Natural Gas,* 320 U.S. at 601.

[1755] *Duquesne,* 488 U.S. at 301-302.

[1756] However, we may not consider incumbent LECs' revenue derived from services not under our jurisdiction. *Smith v. Ill. Bell,* 282 U.S. 133 (1930).

738. In this proceeding, we are establishing pricing rules that should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost methodology enables incumbent LECs to recover a fair return on their investment, *i.e.*, just and reasonable rates. The record does not compel a contrary conclusion. No incumbent LEC has provided persuasive evidence that prices based on a forward- looking economic cost methodology would have a significant impact on its "financial integrity." We further note that at least one federal appellate court has held incremental cost-based pricing constitutional.[1757]

739. Incumbent LECs may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates. We also do not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements. As stated above, we intend to explore this issue in detail in our upcoming access reform proceeding.

740. GTE argues that the proper standard to review our ratemaking methodology is the just compensation standard generally reserved for takings of property. This is in effect a contention that the 1996 Act's physical collocation and unbundled network facility requirements constitute

---

[1757] *Metropolitan Transp. Auth. v. Interstate Commerce Commission,* 792 F.2d 287, 297 (2d Cir.), *cert. denied,* 479 U.S. 1017 (1986).

physical occupation of their property that should be deemed a taking and that must be subject to "just compensation." Assuming for the sake of argument that the physical collocation and unbundled facilities requirements do result in a taking, we nevertheless find that the ratemaking methodology we have adopted satisfies the just compensation standard. Just compensation is normally measured by the fair market value of the property subject to the taking.[1758] Just compensation is not, however, intended to permit recovery of monopoly rents.[1759] The just and reasonable rate standard of TELRIC plus a reasonable allocation of the joint and common costs of providing network elements that we are adopting attempts to replicate, with respect to bottleneck monopoly elements, the rates that would be charged in a competitive market,[1760] and, we believe, is entirely consistent with the just compensation standard. Indeed, a similar rate methodology based on incremental costs has been found to satisfy the just compensation requirement.[1761] For these reasons, we conclude that, even if the 1996 Act's physical

---

[1758] *See, e.g., United States v. Miller*, 317 U.S. 369, 374 (1943) (holding that just compensation can readily be set by ascertaining the property's fair market value, *i.e.*, "what a willing buyer would pay in cash to a willing seller").

[1759] *See, e.g., Lord Mfg. Co. v. United States*, 84 F.Supp. 748, 755-56 (Ct.Cl. 1949), *citing United States v. Cors*, 337 U.S. 325, 334 (1949).

[1760] Compare *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195, 3200-01 (1988).

[1761] *Metropolitan Transp. Auth. v. Interstate Commerce Commission*, 792 F.2d at 297.

collocation and unbundled network facility requirements constitute a taking, a forward-looking economic cost methodology satisfies the Constitution's just compensation standard.

APPENDIX C

5 U.S.C. § 706

§ 706. Scope of review

To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall--

(1) compel agency action unlawfully withheld or unreasonably delayed; and

(2) hold unlawful and set aside agency action, findings, and conclusions found to be--

(A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;

(B) contrary to constitutional right, power, privilege, or immunity;

(C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right;

(D) without observance of procedure required by law;

(E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of an agency hearing provided by statute; or

(F) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court.

In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

APPENDIX D

47 U.S.C. §§ 251 & 252

SEC. 251. [47 U.S.C. 251] INTERCONNECTION.

(a) GENERAL DUTY OF TELECOMMUNICATIONS CARRIERS. - Each telecommunications carrier has the duty -

(1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and

(2) not to install network features, functions, or capabilities that do not comply with the guidelines and standards established pursuant to section 255 or 256.

(b) OBLIGATIONS OF ALL LOCAL EXCHANGE CARRIERS. - Each local exchange carrier has the following duties:

(1) RESALE. - The duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services.

(2) NUMBER PORTABILITY. - The duty to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission.

(3) DIALING PARITY. - The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

(4) ACCESS TO RIGHTS- OF- WAY. - The duty to afford access to the poles, ducts, conduits, and rights-of-

way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224.

(5) RECIPROCAL COMPENSATION. - The duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

(c) ADDITIONAL OBLIGATIONS OF INCUMBENT LOCAL EXCHANGE CARRIERS. - In addition to the duties contained in subsection (b), each incumbent local exchange carrier has the following duties:

(1) DUTY TO NEGOTIATE. - The duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) and this subsection. The requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements.

(2) INTERCONNECTION. - The duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network-

(A) for the transmission and routing of telephone exchange service and exchange access;

(B) at any technically feasible point within the carrier's network;

(C) that is at least equal in quality to that provided by the local exchange carrier to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection; and

(D) on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252.

(3) UNBUNDLED ACCESS. - The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

(4) RESALE. - The duty -

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of

subscribers from offering such service to a different category of subscribers.

(5) NOTICE OF CHANGES. - The duty to provide reasonable public notice of changes in the information necessary for the transmission and routing of services using that local exchange carrier's facilities or networks, as well as of any other changes that would affect the interoperability of those facilities and networks.

(6) COLLOCATION. - The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

(d) IMPLEMENTATION. -

(1) IN GENERAL. - Within 6 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall complete all actions necessary to establish regulations to implement the requirements of this section.

(2) ACCESS STANDARDS. - In determining what network elements should be made available for purposes of subsection (c)(3), the Commission shall consider, at a minimum, whether -

(A) access to such network elements as are proprietary in nature is necessary; and

(B) the failure to provide access to such network elements would impair the ability of

the telecommunications carriers seeking access to provide the services that it seeks to offer.

(3) PRESERVATION OF STATE ACCESS REGULATIONS. - In prescribing and enforcing regulations to implement the requirements of this section, the Commission shall not preclude the enforcement of any regulation, order, or policy of a State commission that -

(A) establishes access and interconnection obligations of local exchange carriers;

(B) is consistent with the requirements of this section; and

(C) does not substantially prevent implementation of the requirements of this section and the purposes of this part.

(e) NUMBERING ADMINISTRATION. -

(1) COMMISSION AUTHORITY AND JURISDICTION.- The Commission shall create or designate one or more impartial entities to administer telecommunications numbering and to make such numbers available on an equitable basis. The Commission shall have exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States. Nothing in this paragraph shall preclude the Commission from delegating to State commissions or other entities all or any portion of such jurisdiction.

(2) COSTS. - The cost of establishing telecommunications numbering administration arrangements and number portability shall be borne by all telecommunications carriers on a competitively neutral basis as determined by the Commission.

(f) EXEMPTIONS, SUSPENSIONS, AND MODIFICATIONS. -

(1) EXEMPTION FOR CERTAIN RURAL TELEPHONE COMPANIES. -

(A) EXEMPTION. - Subsection (c) of this section shall not apply to a rural telephone company until (i) such company has received a bona fide request for interconnection, services, or network elements, and (ii) the State commission determines (under subparagraph (B)) that such request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof).

(B) STATE TERMINATION OF EXEMPTION AND IMPLEMENTATION SCHEDULE.-The party making a bona fide request of a rural telephone company for interconnection, services, or network elements shall submit a notice of its request to the State commission. The State commission shall conduct an inquiry for the purpose of determining whether to terminate the exemption under subparagraph (A). Within 120 days after the State commission receives notice of the request, the State commission shall terminate the exemption if the request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof). Upon termination of the exemption, a State commission shall establish an implementation schedule for compliance with

the request that is consistent in time and manner with Commission regulations.

(C) LIMITATION ON EXEMPTION. - The exemption provided by this paragraph shall not apply with respect to a request under subsection (c) from a cable operator providing video programming, and seeking to provide any telecommunications service, in the area in which the rural telephone company provides video programming. The limitation contained in this subparagraph shall not apply to a rural telephone company that is providing video programming on the date of enactment of the Telecommunications Act of 1996.

(2) SUSPENSIONS AND MODIFICATIONS FOR RURAL CARRIERS. - A local exchange carrier with fewer than 2 percent of the Nation's subscriber lines installed in the aggregate nationwide may petition a State commission for a suspension or modification of the application of a requirement or requirements of subsection (b) or (c) to telephone exchange service facilities specified in such petition. The State commission shall grant such petition to the extent that, and for such duration as, the State commission determines that such suspension or modification -

(A) is necessary -

(i) to avoid a significant adverse economic impact on users of telecommunications services generally;

(ii) to avoid imposing a requirement that is unduly economically burdensome; or

(iii) to avoid imposing a requirement that is technically infeasible; and

(B) is consistent with the public interest, convenience, and necessity.

The State commission shall act upon any petition filed under this paragraph within 100 days after receiving such petition. Pending such action, the State commission may suspend enforcement of the requirement or requirements to which the petition applies with respect to the petitioning carrier or carriers.

(g) CONTINUED ENFORCEMENT OF EXCHANGE ACCESS AND INTERCONNECTION REQUIREMENTS. - On and after the date of enactment of the Telecommunications Act of 1996, each local exchange carrier, to the extent that it provides wireline services, shall provide exchange access information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) that apply to such carrier on the date immediately preceding the date of enactment of the Telecommunications Act of 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment. During the period beginning on such date of enactment and until such restrictions and obligations are so superseded, such restrictions and obligations shall be enforceable in the same manner as regulations of the Commission.

(h) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER. -

(1) DEFINITION. - For purposes of this section, the term "incumbent local exchange carrier" means, with respect to an area, the local exchange carrier that -

(A) on the date of enactment of the Telecommunications Act of 1996, provided telephone exchange service in such area; and

(B)(i) on such date of enactment, was deemed to be a member of the exchange carrier association pursuant to section 69.601(b) of the Commission's regulations (47 C.F.R. 69.601(b)); or

(ii) is a person or entity that, on or after such date of enactment, became a successor or assign of a member described in clause (i).

(2) TREATMENT OF COMPARABLE CARRIERS AS INCUMBENTS. - The Commission may, by rule, provide for treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if -

(A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1);

(B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and

(C) such treatment is consistent with the public interest, convenience, and necessity and the purposes of this section.

(i) SAVINGS PROVISION. - Nothing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201.

SEC. 252. [47 U.S.C. 252] PROCEDURES FOR NEGOTIATION, ARBITRATION, AND APPROVAL OF AGREEMENTS.

(a) AGREEMENTS ARRIVED AT THROUGH NEGOTIATION.

(1) VOLUNTARY NEGOTIATIONS. - Upon receiving a request for interconnection, services, or network elements pursuant to section 251, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251. The agreement shall include a detailed schedule of itemized charges for interconnection and each service or network element included in the agreement. The agreement, including any interconnection agreement negotiated before the date of enactment of the Telecommunications Act of 1996, shall be submitted to the State commission under subsection (e) of this section.

(2) MEDIATION. - Any party negotiating an agreement under this section may, at any point in the negotiation, ask a State commission to participate in the negotiation and to mediate any differences arising in the course of the negotiation.

(b) AGREEMENTS ARRIVED AT THROUGH COMPULSORY ARBITRATION. -

(1) ARBITRATION. - During the period from the 135th to the 160th day (inclusive) after the date on which an incumbent local exchange carrier receives a request for negotiation under this section, the carrier or any other party to the negotiation may petition a State commission to arbitrate any open issues.

(2) DUTY OF PETITIONER. -

(A) A party that petitions a State commission under paragraph (1) shall, at the same time as it submits the petition, provide the State commission all relevant documentation concerning -

(i) the unresolved issues;

(ii) the position of each of the parties with respect to those issues; and

(iii) any other issue discussed and resolved by the parties.

(B) A party petitioning a State commission under paragraph (1) shall provide a copy of the petition and any documentation to the other party or parties not later than the day on which the State commission receives the petition.

(3) OPPORTUNITY TO RESPOND. - A non-petitioning party to a negotiation under this section may respond to the other party's petition and provide such additional information as it wishes within 25 days after the State commission receives the petition.

(4) ACTION BY STATE COMMISSION. -

(A) The State commission shall limit its consideration of any petition under paragraph (1) (and any response thereto) to the issues set forth in the petition and in the response, if any, filed under paragraph (3).

(B) The State commission may require the petitioning party and the responding party to provide such information as may be necessary for the State commission to reach a decision on the unresolved issues. If any party refuses or fails unreasonably to respond on a timely basis

to any reasonable request from the State commission, then the State commission may proceed on the basis of the best information available to it from whatever source derived.

(C) The State commission shall resolve each issue set forth in the petition and the response, if any, by imposing appropriate conditions as required to implement subsection (c) upon the parties to the agreement, and shall conclude the resolution of any unresolved issues not later than 9 months after the date on which the local exchange carrier received the request under this section.

(5) REFUSAL TO NEGOTIATE. - The refusal of any other party to the negotiation to participate further in the negotiations, to cooperate with the State commission in carrying out its function as an arbitrator, or to continue to negotiate in good faith in the presence, or with the assistance, of the State commission shall be considered a failure to negotiate in good faith.

(c) STANDARDS FOR ARBITRATION. - In resolving by arbitration under subsection (b) any open issues and imposing conditions upon the parties to the agreement, a State commission shall -

(1) ensure that such resolution and conditions meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251;

(2) establish any rates for interconnection, services, or network elements according to subsection (d); and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.

(d) PRICING STANDARDS. -

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES. - Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section -

(A) shall be -

(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

(2) CHARGES FOR TRANSPORT AND TERMINATION OF TRAFFIC. -

(A) IN GENERAL. - For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless -

(i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

(ii) such terms and conditions determine such costs on the basis of a reasonable

approximation of the additional costs of terminating such calls.

(B) RULES OF CONSTRUCTION. - This paragraph shall not be construed -

(i) to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements); or

(ii) to authorize the Commission or any State commission to engage in any rate regulation proceeding to establish with particularity the additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls.

(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES. - For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunication service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

(e) APPROVAL BY STATE COMMISSION. -

(1) APPROVAL REQUIRED. - Any interconnection agreement adopted by negotiation or arbitration shall be submitted for approval to the State commission. A State commission to which anagreement is submitte' shall approve or reject the agreement, with written findings as to any deficiencies.

(2) GROUNDS FOR REJECTION. - The State commission may only reject -

(A) an agreement (or any portion thereof) adopted by negotiation under subsection (a) if it finds that -

(i) the agreement (or portion thereof) discriminates against a telecommunications carrier not a party to the agreement; or

(ii) the implementation of such agreement or portion is not consistent with the public interest, convenience, and necessity; or

(B) an agreement (or any portion thereof) adopted by arbitration under subsection (b) if it finds that the agreement does not meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251, or the standards set forth in subsection (d) of this section.

(3) PRESERVATION OF AUTHORITY. - Notwithstanding paragraph (2), but subject to section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of an agreement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(4) SCHEDULE FOR DECISION. - If the State commission does not act to approve or reject the agreement within 90 days after submission by the parties of an agreement adopted by negotiation under subsection (a), or within 30 days after submission by the parties of an agreement adopted by arbitration under subsection (b), the agreement shall be deemed

approved. No State court shall have jurisdiction to review the action of a State commission in approving or rejecting an agreement under this section.

(5) COMMISSION TO ACT IF STATE WILL NOT ACT. - If a State commission fails to act to carry out its responsibility under this section in any proceeding or other matter under this section, then the Commission shall issue an order preempting the State commission's jurisdiction of that proceeding or matter within 90 days after being notified (or taking notice) of such failure, and shall assume the responsibility of the State commission under this section with respect to the proceeding or matter and act for the State commission.

(6) REVIEW OF STATE COMMISSION ACTIONS. - In a case in which a State fails to act as described in paragraph (5), the proceeding by the Commission under such paragraph and any judicial review of the Commission's actions shall be the exclusive remedies for a State commission's failure to act. In any case in which a State commission makes a determination under this section, any party aggrieved by such determination may bring an action in an appropriate Federal district court to determine whether the agreement or statement meets the requirements of section 251 and this section.

(f) STATEMENTS OF GENERALLY AVAILABLE TERMS.-

(1) IN GENERAL. - A Bell operating company may prepare and file with a State commission a statement of the terms and conditions that such company generally offers within that State to comply with the requirements of section 251 and the regulations thereunder and the standards applicable under this section.

(2) STATE COMMISSION REVIEW. - A State commission may not approve such statement unless such statement complies with subsection (d) of this section and section 251 and the regulations thereunder. Except as provided in section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of such statement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(3) SCHEDULE FOR REVIEW. - The State commission to which a statement is submitted shall, not later than 60 days after the date of such submission -

(A) complete the review of such statement under paragraph (2) (including any reconsideration thereof), unless the submitting carrier agrees to an extension of the period for such review; or

(B) permit such statement to take effect.

(4) AUTHORITY TO CONTINUE REVIEW. - Paragraph (3) shall not preclude the State commission from continuing to review a statement that has been permitted to take effect under subparagraph (B) of such paragraph or from approving or disapproving such statement under paragraph (2).

(5) DUTY TO NEGOTIATE NOT AFFECTED. - The submission or approval of a statement under this subsection shall not relieve a Bell operating company of its duty to negotiate the terms and conditions of an agreement under section 251.

(g) CONSOLIDATION OF STATE PROCEEDINGS. - Where not inconsistent with the requirements of this Act, a State commission may, to the extent practical, consolidate

proceedings under sections 214(e), 251(f), 253, and this section in order to reduce administrative burdens on telecommunications carriers, other parties to the proceedings, and the State commission in carrying out its responsibilities under this Act.

(h) FILING REQUIRED. - A State commission shall make a copy of each agreement approved under subsection (e) and each statement approved under subsection (f) available for public inspection and copying within 10 days after the agreement or statement is approved. The State commission may charge a reasonable and nondiscriminatory fee to the parties to the agreement or the party filing the statement to cover the costs of approving and filing such agreement or statement.

(i) AVAILABILITY TO OTHER TELECOMMUNICATIONS CARRIERS. - A local exchange carrier shall make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.

(j) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER. - For purposes of this section, the term "incumbent local exchange carrier" has the meaning provided in section 251(h).

APPENDIX E

47 C.F.R. §§ 51.501 - 51.511

§ 51.501 Scope.

(a) The rules in this subpart apply to the pricing of network elements, interconnection, and methods of obtaining access to unbundled elements, including physical collocation and virtual collocation.

(b) As used in this subpart, the term "element" includes network elements, interconnection, and methods of obtaining interconnection and access to unbundled elements.

§ 51.503 General pricing standard.

(a) An incumbent LEC shall offer elements to requesting telecommunications carriers at rates, terms, and conditions that are just, reasonable, and nondiscriminatory.

(b) An incumbent LEC's rates for each element it offers shall comply with the rate structure rules set forth in §§ 51.507 and 51.509, and shall be established, at the election of the state commission-

(1) Pursuant to the forward-looking economic cost-based pricing methodology set forth in §§ 51.505 and 51.511; or

(2) Consistent with the proxy ceilings and ranges set forth in § 51.513.

(c) The rates that an incumbent LEC assesses for elements shall not vary on the basis of the class of customers served by the requesting carrier, or on the type of services that the requesting carrier purchasing such elements uses them to provide.

§ 51.505 Forward-looking economic cost.

(a) In general. The forward-looking economic cost of an element equals the sum of:

(1) The total element long-run incremental cost of the element, as described in paragraph (b); and

(2) A reasonable allocation of forward-looking common costs, as described in paragraph (c).

(b) Total element long-run incremental cost. The total element long-run incremental cost of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(1) Efficient network configuration. The total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

(2) Forward-looking cost of capital. The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element.

(3) Depreciation rates. The depreciation rates used in calculating forward- looking economic costs of elements shall be economic depreciation rates.

(c) Reasonable allocation of forward-looking common costs--

(1) Forward-looking common costs. Forward-looking common costs are economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent LEC) that cannot be attributed directly to individual elements or services.

(2) Reasonable allocation.

(i) The sum of a reasonable allocation of forward-looking common costs and the total element long-run incremental cost of an element shall not exceed the stand-alone costs associated with the element. In this context, stand-alone costs are the total forward-looking costs, including corporate costs, that would be incurred to produce a given element if that element were provided by an efficient firm that produced nothing but the given element.

(ii) The sum of the allocation of forward-looking common costs for all elements and services shall equal the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LEC's total network, so as to provide all the elements and services offered.

(d) Factors that may not be considered. The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:

(1) Embedded costs. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts;

(2) Retail costs. Retail costs include the costs of marketing, billing, collection, and other costs associated with offering retail telecommunications services to subscribers who are not telecommunications carriers, described in § 51.609;

(3) Opportunity costs. Opportunity costs include the revenues that the incumbent LEC would have received for the sale of telecommunications services, in the absence of competition from telecommunications carriers that purchase elements; and

(4) Revenues to subsidize other services. Revenues to subsidize other services include revenues associated with

elements or telecommunications service offerings other than the element for which a rate is being established.

(e) Cost study requirements. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward- looking economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511.

(1) A state commission may set a rate outside the proxy ranges or above the proxy ceilings described in § 51.513 only if that commission has given full and fair effect to the economic cost based pricing methodology described in this section and § 51.511 in a state proceeding that meets the requirements of paragraph (e)(2) of this section.

(2) Any state proceeding conducted pursuant to this section shall provide notice and an opportunity for comment to affected parties and shall result in the creation of a written factual record that is sufficient for purposes of review. The record of any state proceeding in which a state commission considers a cost study for purposes of establishing rates under this section shall include any such cost study.

§ 51.507 General rate structure standard.

(a) Element rates shall be structured consistently with the manner in which the costs of providing the elements are incurred.

(b) The costs of dedicated facilities shall be recovered through flat-rated charges.

(c) The costs of shared facilities shall be recovered in a manner that efficiently apportions costs among users. Costs of shared facilities may be apportioned either through usage-sensitive charges or capacity-based flat-rated charges, if the state commission finds that such rates reasonably reflect the

costs imposed by the various users.

(d) Recurring costs shall be recovered through recurring charges, unless an incumbent LEC proves to a state commission that such recurring costs are de minimis. Recurring costs shall be considered de minimis when the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

(e) State commissions may, where reasonable, require incumbent LECs to recover nonrecurring costs through recurring charges over a reasonable period of time. Nonrecurring charges shall be allocated efficiently among requesting telecommunications carriers, and shall not permit an incumbent LEC to recover more than the total forward-looking economic cost of providing the applicable element.

(f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.

(1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in § 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.

(2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

§ 51.509 Rate structure standards for specific elements.

In addition to the general rules set forth in § 51.507, rates for specific elements shall comply with the following rate structure rules.

(a) Local loops. Loop costs shall be recovered through flat-rated charges.

(b) Local switching. Local switching costs shall be recovered through a combination of a flat-rated charge for line ports and one or more flat-rated or per-minute usage charges for the switching matrix and for trunk ports.
(c) Dedicated transmission links. Dedicated transmission link costs shall be recovered through flat-rated charges.
(d) Shared transmission facilities between tandem switches and end offices. The costs of shared transmission facilities between tandem switches and end offices may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(e) Tandem switching. Tandem switching costs may be recovered through usage- sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(f) Signaling and call-related database services. Signaling and call-related database service costs shall be usage-sensitive, based on either the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, the cost of which shall be recovered through flat- rated charges.
(g) Collocation. Collocation costs shall be recovered consistent with the rate structure policies established in the Expanded Interconnection proceeding, CC Docket No. 91-141.

§ 51.511 Forward-looking economic cost per unit.

(a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the

element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.

(b)(1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the discrete number of elements (e.g., local loops or local switch ports) that the incumbent LEC uses or provides.

(2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the unit of measurement of the usage (e.g., minutes of use or call-related database queries) of the element.

APPENDIX F

The following is a list of parties to the Eighth Circuit proceedings that are not listed in the caption of the decision below (*see* Appendix A):

Ad Hoc Telecommunications Users Committee
Airtouch Communications, Inc.
Alabama Public Service Commission
American Communications Services, Inc.
Ameritech Corporation
Anaheim, California Public Utilities Department
AT&T Corporation
Cincinnati Bell Telephone Company
Citizens Telephone Company of Kecksburg
Comcast Corporation
Concord Telephone Company
Consumers' Utility Counsel Division, Governor's Office of Consumer Affairs
Department of Public Utilities of the Commonwealth of Massachusetts
Excel Telecommunications, Inc.
Federal Communications Commission
General Communications, Inc.
GST Telecom, Inc.
ICG Telecom Group, Inc.
Information Technology Industry Council
Iowa Utilities Board
Jones Intercable, Inc.
Kansas Corporation Commission
Kentucky Public Service Commission
KMC Telecom, Inc.

Maryland Public Service Commission
MCI Telecommunications Corporation
Mid-Sized Incumbent Local Exchange Carriers
Mississippi Public Service Commission
National Cable Television Association
National Rural Telecom Association
National Telephone Cooperative Association
New York State Department of Public Service
North Carolina Utilities Commission
North State Telephone Company
Oregon Public Utility Commission
Organization for the Promotion and Advancement of Small Telecommunications Companies
Pennsylvania Public Utility Commission
People of the State of California & PUC of California
Public Utilities Commission of the State of Colorado
Public Service Commission of Wisconsin
Public Service Commission of the State of Montana
Qwest Communications
Rock Hill Telephone Company
Roseville Telephone Company
Rural Telecommunications Group
Rural Telephone Coalition
South Dakota Public Utilities Commission
Sprint Communications Company
Sprint Corporation
Sprint PCS
Sprint Spectrum, L.P.
State of Texas
Telecommunications Resellers Association
Texas Office of Public Utility Counsel
The Ad Hoc Coalition of Telecommunications Manufacturing Companies

The Competition Policy Institute
United States of America
US Telephone Association
Virginia State Corporation Commission
Winstar Communications

(2) (2) (2) (2)

Supreme Court, U.S.
FILED
NOV 17 2000
CLERK

No.s 00-511, 00-555, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

WORLDCOM, INC., ET AL., PETITIONERS

v.

VERIZON COMMUNICATIONS, INC., ET AL.

AT&T CORP., PETITIONER

v.

IOWA UTILITIES BOARD, ET AL.

GENERAL COMMUNICATIONS, INC., PETITIONER

v.

IOWA UTILITIES BOARD, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES

SETH P. WAXMAN
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

CHRISTOPHER J. WRIGHT
General Counsel
Federal Communications Commission
Washington, D.C. 20554

26 RD

QUESTIONS PRESENTED

The questions presented in the petitions are those presented in our petition for a writ of certiorari in *Federal Communications Commission* v. *Iowa Utilities Board*, No. 00-587 (filed Oct. 13, 2000), as well as the following:

1. Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

2. Whether the court of appeals erred in invalidating certain of the Federal Communications Commission's rules concerning the applicability to rural and small local exchange carriers of certain obligations imposed by the Telecommunications Act—specifically, those rules that (a) construe the "unduly economically burdensome" standard of 47 U.S.C. 251(f) and (b) impose the burden of proof in proceedings under 47 U.S.C. 251(f)(1) on the carrier seeking to be excused from its obligations under the Act.

3. Whether the court of appeals erred in invalidating the Federal Communications Commission's rule governing the "wholesale rates" that incumbent local exchange carriers may charge when providing their retail services to new entrants for resale under 47 U.S.C. 251(c)(4) and 252(d)(3).

TABLE OF CONTENTS

	Page
Opinions below	2
Jurisdiction	2
Statement	2
Discussion	8
Conclusion	21

TABLE OF AUTHORITIES

Cases:

AT&T Corp. v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999)	5, 15
Baltimore & Ohio R.R. v. *United States*, 345 U.S. 146 (1953)	12
Brooks-Scanlon Co. v. *Railroad Comm'n*, 251 U.S. 396 (1920)	12
Chevron U.S.A. Inc. v. *NRDC*, 467 U.S. 837 (1984)	18
Duquesne Light Co. v. *Barasch*, 488 U.S. 299 (1989)	11, 12, 13
FERC v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979)	11
FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944)	11
GTE Serv. Corp. v. *FCC*, cert. dismissed No. 99-1244 (Nov. 2, 2000)	13, 20
Iowa Utils. Bd. v. *FCC*, 120 F.3d 753 (8th Cir. 1997)	5
Market St. Ry. Co. v. *Railroad Comm'n*, 324 U.S. 548 (1945)	11
National Mining Ass'n v. *Babbitt*, 172 F.3d 906 (D.C. Cir. 1999)	10
National Rural Telecom Ass'n v. *FCC*, 988 F.2d 174 (D.C. Cir. 1993)	14
NLRB v. *Transportation Mgmt. Corp.*, 462 U.S. 393 (1983)	17

Cases—Continued: Page

United States v. *Miller*, 317 U.S. 369 (1943) 10
United States v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985) 10
Valuation Proceedings Under Sections 303(c) and 306 of the Reg. Rail Reorganization Act, In re, 439 F. Supp. 1351 (Spec. Ct. 1977) 12

Constitution, statutes and regulations:

U.S. Const. Amend. V (Takings Clause) 10, 11
Communications Act of 1934, 47 U.S.C. 153(37) (Supp. IV 1998) 3
Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (47 U.S.C. 251 *et seq.*) 2-3
Title I:
47 U.S.C. 251 (Supp. IV 1998) 21
47 U.S.C. 251(b) (Supp. IV 1998) 4
47 U.S.C. 251(c) (Supp. IV 1998) 3, 4, 6, 8, 16, 17
47 U.S.C. 251(c)(2) (Supp. IV 1998) 3
47 U.S.C. 251(c)(3) (Supp. IV 1998) 3, 8, 14
47 U.S.C. 251(c)(4) (Supp. IV 1998) 3, 7
47 U.S.C. 251(c)(4)(A) (Supp. IV 1998) 7
47 U.S.C. 251(d)(2) (Supp. IV 1998) 14
47 U.S.C. 251(f) (Supp. IV 1998) 3, 4, 5, 6, 9, 16, 20, 21
47 U.S.C. 251(f)(1) (Supp. IV 1998) 3, 4, 6, 17, 18
47 U.S.C. 251(f)(1)(A) (Supp. IV 1998) 3, 18
47 U.S.C. 251(f)(1)(B) (Supp. IV 1998) 3, 18
47 U.S.C. 251(f)(2) (Supp. IV 1998) 3, 4
47 U.S.C. 252(d)(1) (Supp. IV 1998) 9, 10
47 U.S.C. 252(d)(1)(A) (Supp. IV 1998) 10
47 U.S.C. 252(d)(3) (Supp. IV 1998) 7, 8, 9, 18, 19, 20
47 U.S.C. 254 (Supp. IV 1998) 3, 6

Statutes and regulations–Continued: Page

47 U.S.C. 271 (Supp. IV 1998) 12
Title VI, § 601(a)(2), 110 Stat. 143 (47 U.S.C. 152 note) 12
47 C.F.R.:
Pt. 51:
Section 51.315(c)-(f) 9, 20
Sections 51.401-51.405 4
Section 51.405 ..... 5, 17
Section 51.405(c) 4, 6, 16, 17
Section 51.405(d) 4, 6, 16
Section 51.609(b) 8
Section 51.609(c)-(e) 8

Miscellaneous:

Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999) 13
Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, First Report & Order (Local Competition Order), In re, 11 F.C.C.R. 15,499 (1996) 4
Implementation of the Local Competition Provisions of the Telecomm. Act of 1996, In re, 15 F.C.C.R. 3696 (1999), petitions for review filed *sub nom. United States Telecom Ass'n* v. *FCC*, Nos. 00-1015 and 00-1025 15
Interstate Rate of Return Summary, Years 1991 Through 1999 (FCC Apr. 4, 2000) (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror99.pdf) 11

In the Supreme Court of the United States

No. 00-511

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

No. 00-555

WORLDCOM, INC., PETITIONERS

v.

VERIZON COMMUNICATIONS, INC., ET AL.

No. 00-590

AT&T CORP., PETITIONER

v.

IOWA UTILITIES BOARD, ET AL.

No. 00-602

GENERAL COMMUNICATIONS, INC., PETITIONER

v.

IOWA UTILITIES BOARD, ET AL.

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Verizon Pet. App. 1a-43a; WorldCom Pet. App. 1a-34a; AT&T Pet. App. 1a-38a; GCI Pet. App. 1a-37a) is reported at 219 F.3d 744. The Order of the Federal Communications Commission (excerpted in Verizon Pet App. 44a-151a; WorldCom Pet. App. 39a-133a; AT&T Pet. App. 39a-202a; GCI Pet. App. 38a-85a) is reported at 11 F.C.C.R. 15,499.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. Verizon Communications Inc., *et al.*, (Verizon) filed a petition for a writ of certiorari on October 4, 2000; WorldCom, Inc., filed a petition for a writ of certiorari on October 10, 2000; AT&T Corp. filed a petition for a writ of certiorari on October 13, 2000; and General Communications, Inc. (GCI), filed a petition for a writ of certiorari on October 16, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

On October 13, 2000, the Federal Communications Commission (FCC) and the United States filed a petition for a writ of certiorari in *Federal Communications Commission* v. *Iowa Utilities Board*, No. 00-587 (U.S. Pet.). That petition seeks review of the same court of appeals decision at issue in the petitions to which this brief responds. Our petition sets forth the statutory scheme and the procedural background of this case in detail, and we refer the Court to that discussion.

1. a. As explained in our petition (at 3-4), Congress enacted the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56 (codified at 47 U.S.C.

251 *et seq.*), to open local telecommunications markets to full competition.[1] To that end, the 1996 Act imposes several requirements on incumbent local exchange carriers (incumbent LECs), the carriers that have historically exercised monopoly control over local telecommunications markets. Section 251(c)(3) requires that new entrants be able to gain "access" to (*i.e.*, to lease) an incumbent LEC's "network elements," such as loops, switching capability, and other components and capabilities of the incumbent's network. Section 251(c)(2) requires that new entrants be able to "interconnect[]" their own facilities with those in the incumbent's network. And Section 251(c)(4) requires that new entrants be able to purchase an incumbent's retail services "at wholesale rates" and to resell those services to end users.

In Section 251(f), Congress qualified the applicability of those requirements with respect to two discrete categories of small LECs. First, Section 251(f)(1) exempts a "rural telephone company," as defined in 47 U.S.C. 153(37), from the obligations of Section 251(c) until the company receives "a bona fide request" from another carrier "for interconnection, services, or network elements" under Section 251(c). 47 U.S.C. 251(f)(1)(A). Section 251(f)(1) further provides that a state public utility commission, within 120 days after receiving notice of the request, "shall terminate the exemption if the request is not unduly economically burdensome, is technically feasible, and is consistent with" most provisions of 47 U.S.C. 254, which addresses universal service issues. 47 U.S.C. 251(f)(1)(B).

Second, Section 251(f)(2) separately establishes conditions under which "[a] local exchange carrier with

---

[1] All citations of the 1996 Act are of Supp. IV 1998.

fewer than 2 percent of the Nation's subscriber lines" may apply for a suspension or modification of the requirements of 47 U.S.C. 251(b) and (c). The statute authorizes state public utility commissions to grant such applications "to the extent that, and for such duration as," the suspension or modification is "consistent with the public interest" and "necessary" to "avoid a significant adverse economic impact on users of telecommunications services generally," to "avoid imposing a requirement that is unduly economically burdensome," or to "avoid imposing a requirement that is technically infeasible." 47 U.S.C. 251(f)(2). The state commission has 180 days to act on a petition for suspension or modification.

b. In the *Local Competition Order*, the FCC adopted rules to guide state public utility commissions in their application of Section 251(f). *In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, First Report & Order (Local Competition Order)*, 11 F.C.C.R. 15,499, ¶¶ 1255-1265 (1996) (reprinted in AT&T Pet. App. 186a-195a); 47 C.F.R. 51.401-51.405. The FCC construed the "unduly economically burdensome" language of Section 251(f)(1) to mean that, in order to justify a continued exemption once a "bona fide request" has been made, a rural telephone company must demonstrate "that the application of the requirements of section 251(c) of the Act would be likely to cause undue economic burden beyond the economic burden that is typically associated with efficient competitive entry." 47 C.F.R. 51.405(c). The FCC took a similar approach with respect to the "unduly economically burdensome" standard of Section 251(f)(2) applicable to small local exchange carriers. 47 C.F.R. 51.405(d).

In adopting that approach, the FCC reasoned that Congress "did not intend to insulate smaller or rural LECs from competition, and thereby prevent subscribers in those communities from obtaining the benefits of competitive local exchange service." AT&T Pet. App. 193a. Instead, the FCC explained, Congress "intended exemption, suspension, or modification of the section 251 requirements to be the exception rather than the rule, and to apply only to the extent, and for the period of time, that policy considerations justify" such special treatment. *Ibid.*

The FCC then turned to the question of which party —the requesting carrier or the carrier seeking the exemption, suspension, or modification—should bear the burden of proof in disputes arising under Section 251(f). The FCC determined that the burden of proof appropriately rests with the carrier seeking the exemption, suspension, or modification, because that carrier is "the party seeking relief from otherwise applicable requirements," because that carrier "is in control of the relevant information necessary for the state to make a determination regarding the request," and, more generally, because placing the burden on that carrier ensures consistency with "the pro-competitive focus of the 1996 Act." AT&T Pet. App. 193a-194a; see 47 C.F.R. 51.405 (codifying rule).

c. In its initial 1997 decision, the court of appeals held that the FCC lacked statutory jurisdiction to issue rules implementing Section 251(f). *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 802 (8th Cir. 1997). This Court reversed and remanded for consideration of the FCC's rules on the merits. See *AT&T* v. *Iowa Utils. Bd.*, 525 U.S. 366, 385 (1999) (*Iowa Utils. Bd. I*).

On remand, in the ruling under review here, the Eighth Circuit invalidated the FCC's implementation of

Section 251(f) in two principal respects. First, the court held that the FCC's construction of the phrase "undue economic burden" in 47 C.F.R. 51.405(c) and (d) improperly "eliminat[ed]" any consideration of the "economic burden that is typically associated with efficient competitive entry." AT&T Pet. App. 29a. The court, reasoning that the statutory language "looks to the whole of the economic burden the request imposes, not just a discrete part," concluded that the FCC had "impermissibly weakened the broad protection Congress granted to small and rural telephone companies." *Id.* at 30a.[2]

Second, the court of appeals invalidated the FCC's determination that an incumbent LEC must bear the burden of proof in proceedings under Section 251(f)(1). AT&T Pet. App. 30a-32a. Observing that a rural LEC's exemption remains in effect until it is "terminate[d]" in state proceedings, the court held that the "plain meaning of the statute requires the party making the request [under Section 251(c)] to prove that the request meets the three prerequisites" for termination of the exemption. *Id.* at 32a.

2. a. As noted above (at 3), the 1996 Act requires incumbent LECs to offer certain of their retail services

[2] The court of appeals vacated 47 C.F.R. 51.405(c) on an additional ground. The court reasoned that the rule, if read in isolation, could be construed as conditioning any exemption on an incumbent's ability to satisfy the FCC's interpretation of "undue economic burden," and thus as requiring state commissions to "disregard[] two of the three statutory requirements that must be met before a state commission can terminate an exemption" (*i.e.*, technical feasibility and consistency with Section 254). AT&T Pet. App. 27a. At the same time, the court acknowledged that, in an order issued after the one under review here, the FCC had clarified that the regulation should *not* be so interpreted. *Ibid.*

at "wholesale rates" to competitors, which may then resell those services to their own subscribers. 47 U.S.C. 251(c)(4)(A). In the *Local Competition Order*, the FCC observed that such "[r]esale will be an important entry strategy for many new entrants, especially in the short term when they are building their own facilities." AT&T Pet. App. 165a. "[I]n some areas and for some new entrants," the FCC added, "we expect that the resale option will remain an important entry strategy over the longer term." *Ibid.*

The 1996 Act directs that the "wholesale rates" described in Section 251(c)(4) be determined "on the basis of retail rates * * *, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." 47 U.S.C. 252(d)(3). In the *Local Competition Order*, the FCC determined that, in establishing the "costs that will be avoided" for purposes of that provision, a state public utility commission should include "all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business." AT&T Pet. App. 168a. "In other words," the FCC explained, "the avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers." *Ibid.* The FCC specifically rejected the argument "that the LEC must actually experience a reduction in its operating expenses for a cost to be considered 'avoided' for purposes of section 252(d)(3)." *Ibid.* The FCC explained that Congress did not intend "to allow incumbent LECs to sustain artificially high wholesale prices by declining to reduce their expenditures to the degree that certain costs are readily avoidable." *Ibid.* The FCC codified its approach in a regulation stating that state commissions should

exclude "those costs that reasonably can be avoided when an incumbent LEC provides a telecommunications service for resale at wholesale rates to a requesting carrier." 47 C.F.R. 51.609(b); see 47 C.F.R. 51.609(c)-(e) (specifying categories of retail-oriented costs).

b. On remand from this Court's decision reinstating the FCC's jurisdiction to implement the pricing rules of Section 251(c), the Eighth Circuit invalidated, on the merits, the FCC's interpretation of the wholesale pricing standard. The court of appeals reasoned that "the phrase 'will be avoided' [in 47 U.S.C. 252(d)(3)] refers to those costs that the [incumbent LEC] will actually avoid incurring in the future, because of its wholesale efforts, not costs that 'can be avoided.'" AT&T Pet. App. 17a. Thus, the court concluded that "[t]he plain meaning of the statute" requires that only those "costs that are actually avoided, not those that could be or might be avoided, should be excluded" from an incumbent LEC's retail rates in calculating the wholesale rates to be charged new entrants. *Ibid.*

DISCUSSION

In No. 00-511, Verizon seeks this Court's review of its claim that, when leasing network elements to competitors pursuant to 47 U.S.C. 251(c)(3), an incumbent is entitled to charge rates based on the "historical" cost of those elements, *i.e.*, the costs reflected on its accounting books. Although that claim is without merit, it is nonetheless related to the question presented in our petition for a writ of certiorari in No. 00-587, and we therefore do not oppose Verizon's petition so long as our petition is granted. In Nos. 00-555, 00-590, and 00-602, petitioners challenge, *inter alia*, portions of the decision below invalidating the FCC's rules with

respect to exemptions, suspensions, and modifications for small and rural LECs under Section 251(f) and the wholesale pricing standard under Section 252(d)(3). As discussed below, although we did not include those issues in our own petition, the Court could appropriately decide to grant certiorari with respect to them as well.[3]

1. Section 252(d)(1) provides that the rates that an incumbent LEC may charge for the use of its network elements shall be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the * * * element" and "may include a reasonable profit." 47 U.S.C. 252(d)(1). As discussed in our petition (at 3-8, 16-20), the FCC reasonably implemented that provision to ensure recovery of the forward-looking cost of network elements: *i.e.*, the cost of replacing the functions of network assets on today's market. The FCC rejected, as economically unsound and inconsistent with the 1996 Act's pro-competitive objectives, the argument that Verizon renews here: that "compensation for network elements must recover the historical costs reflected on incumbents' books." Verizon Pet. 11; see U.S. Pet. 6-7. The Eighth Circuit upheld the FCC's determination on that point (Verizon Pet. App. 10a-18a), and Verizon challenges that portion of the court's decision.[4]

---

[3] AT&T and WorldCom also seek review of the Eighth Circuit's invalidation of (i) a portion of the FCC's pricing rules for network elements and interconnection and (ii) the FCC's "combinations rules" in 47 C.F.R. 51.315(c)-(f). We have presented those issues in our own petition.

[4] In the court of appeals, some incumbent LECs separately claimed an entitlement to recover, through the rates for network elements (rather than some other mechanism), implicit subsidies for providing universal service. The Eighth Circuit rejected that

Verizon focuses not on the text of Section 252(d)(1), but on the principle of constitutional avoidance. It argues that, to avoid a Takings Clause violation, Section 252(d)(1) must be construed to allow an incumbent to recover whatever it actually paid in the past for the elements that it now leases to new entrants. In the Takings Clause context, however, this Court and others have persistently rejected efforts to resort to the avoidance principle to "frustrate[] permissible applications of a statute or regulation" absent a concrete showing that government action will necessarily produce confiscatory results. *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 (1985); see *National Mining Ass'n* v. *Babbitt*, 172 F.3d 906, 917 (D.C. Cir. 1999). Verizon can make no such showing here.

As an initial matter, when the government commits private property to public uses (*e.g.*, when condemning a house), it does not compensate the property owner in the amount that he or she paid for the property in the past. Instead, the government pays the owner the fair market value of the property—*i.e.*, "what a willing buyer would pay in cash to a willing seller" in today's market. *United States* v. *Miller*, 317 U.S. 369, 374 (1943). A methodology based on fair market value is analogous to a methodology based on forward-looking costs.[5] What Verizon seeks here, in contrast, is a

claim on the ground that, whereas Section 252(d)(1)(A) "requires rates to be cost-based," "[u]niversal service charges are not based on the actual costs of providing * * * the requested network element." U.S. Pet. App. 15a. No party has sought review of the Eighth Circuit's ruling on that point.

[5] In many cases, the forward-looking cost of a network asset may actually *exceed* its fair market value, because the asset can be replaced in today's market only by an asset that has more sophisticated capabilities and therefore commands a higher price.

compensation rule entitling it to recover its historical costs for its assets, even when those costs far exceed the fair market value of those assets. The Takings Clause does not compel that result.

Verizon's argument is particularly unsound because incumbent LECs, as regulated public utilities, are subject to the regulatory takings analysis of *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299 (1989), and *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). In *Duquesne*, the Court specifically rejected the argument that the Takings Clause entitles a utility to recover all of its prudently incurred historical costs. See 488 U.S. at 301-302, 307-316; accord *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517-520 (1979); *Market St. Ry.* v. *Railroad Comm'n*, 324 U.S. 548, 553-554, 564-568 (1945). The Court explained that the Constitution protects a public utility only from "the net effect of the rate order on its property," *Duquesne*, 488 U.S. at 314, so that "[i]f the total effect of the rate order cannot be said to be unreasonable, judicial inquiry * * * is at an end," *id.* at 310 (quoting *Hope*, 320 U.S. at 602). Here, as in *Duquesne*, "[n]o argument has been made" that the regulatory measure at issue "jeopardize[s] the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Id.* at 312. To the contrary, Verizon and its fellow petitioners have generally enjoyed quite healthy returns in recent years.[6] Moreover, the 1996 Act as a whole confers very significant bene-

[6] See *Interstate Rate of Return Summary, Years 1991 Through 1999* (FCC Apr. 4, 2000) (http://www.fcc.gov/Bureaus/Common_Carrier/ Reports/FCC-State_Link/IAD/ror99.pdf).

fits on those carriers by, for example, eliminating or reducing restrictions on their entry into the long-distance market. See 47 U.S.C. 271 (prescribing method whereby Bell companies may obtain permission to enter that market); 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (relieving GTE from restrictions on provision of long-distance service).[7]

There is, moreover, no merit to Verizon's contention (Pet. 15-16) that the FCC's use of a forward-looking approach is inconsistent with *Duquesne* on the theory that the FCC has improperly "switche[d]" compensation methodologies. To begin with, *Duquesne* specifically *affirms* the discretion of regulators to alter rate-setting methodologies to accommodate changes in regulatory policy, even if, as in *Duquesne* itself, the new methodology results in "stranded" investments.[8]

---

[7] Verizon cites *Brooks-Scanlon Co.* v. *RailroadComm'n*, 251 U.S. 396 (1920), for the proposition that, in determining the "total effect" of a methodological decision for purposes of *Duquesne*, regulators must altogether disregard profits "earn[ed] in competitive lines of business." Pet. 17. *Brooks-Scanlon* holds no such thing. The Court there held that the government could not force a company engaged in an *unregulated* "sawmill and lumber business" to conduct, in addition, an unprofitable railroad operation. 251 U.S. at 399. No similar arrangement is at issue here. The "net effects" inquiry mandated by *Duquesne* may, at a minimum, take into account a utility company's overall rate of return with respect to its interrelated *regulated* activities. See, *e.g.*, *Baltimore & Ohio R.R.* v. *United States*, 345 U.S. 146, 148-150 (1953); see also *In re Valuation Proceedings Under Sections 303(c) and 306 of the Reg'l Rail Reorganization Act*, 439 F. Supp. 1351, 1357 n.12 (Spec. Ct. 1977) (Friendly, J.) (noting that modern Takings Clause jurisprudence has superseded the language in *Brooks-Scanlon* upon which petitioners rely).

[8] In *Duquesne*, the Court upheld a state law that "suddenly and selectively" (488 U.S. at 313) foreclosed recovery of a $35 million investment that was prudent when made, even though the "prudent investment" methodology in effect at the time of the investment would have provided for such recovery. The takings claim here is even weaker than in *Duquesne*. Although the essentials of the FCC's forward-looking cost methodology have governed the industry for more than four years (see U.S. Pet. 20-21), petitioners make no effort to document any concrete claim of "stranded" investments. Compare Verizon Pet. 8 (alleging "stranding" of investments) with *id.* at 16-17 (declining to make any empirical argument about practical consequences of employing TELRIC). Any such claim would be highly suspect on a variety of legal and factual grounds, as we have explained elsewhere. See U.S. Br. at 38-40 & n.32, *GTE Serv. Corp.* v. *FCC*, cert. dismissed, No. 99-1244 (Nov. 2, 2000); see generally Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999). In all events, any remedy, if a need for one were established, would be appropriately obtained not through the rates charged for network elements, but through a competitively neutral funding mechanism, as the FCC has explained. See U.S. Pet. App. 95a (FCC "do[es] not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements.").

Second, *Duquesne* does not hold, as petitioners allege (Pet. 15), that a change in methodologies is permissible only if the new methodology produces a constitutionally adequate rate of return "*as measured under the prior system.*" See *Duquesne*, 488 U.S. at 312 (stating sufficient, but not necessary, basis for rejecting constitutional claim). And, even if *Duquesne* did so hold, that would not assist petitioners here, because they make no effort to show that the "overall impact" (*ibid.*) of adopting a forward-looking methodology for network elements leaves them with a confiscatory overall return.

In any event, Verizon's argument rests on the false premise that, in implementing the local competition provisions of the 1996 Act, the FCC "abrupt[ly]

jettison[ed]" the use of "historical costs" (Pet. 15). To begin with, Verizon's argument on this point mixes apples and oranges. The historical cost methodology to which Verizon refers (see *id.* at 5) was generally used by state and federal regulators in setting retail rates and charges for particular services, not in setting rates that new entrants must pay incumbents to lease network elements. Those quite different contexts present quite different issues. And, even in the context of setting retail rates, both the FCC and many state commissions largely abandoned a pure historical cost approach many years ago because of its long-recognized methodological shortcomings. See, *e.g.*, *National Rural Telecom Ass'n* v. *FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

Finally, Verizon challenges (Pet. 10) the FCC's pricing rules on policy grounds, claiming that the use of forward-looking costs in this setting will produce "a sort of 'Potemkin village' competition" with a "rapid proliferation" of competitors providing service solely through the use of an incumbent's own facilities. To begin with, the policy concern that petitioners profess is analytically unhinged from the legal claim that they are making here. Congress, not the FCC, made the basic decision to jump-start competition by entitling competitors to enter local markets by leasing certain elements in the incumbent's network rather than duplicating all such elements on their own. See U.S. Pet. 6-7; 47 U.S.C. 251(c)(3) and (d)(2). Even if (as petitioners wrongly suggest) there were some plausible policy justification for slowing competition down or giving new entrants additional incentives to invest *immediately* in their own facilities, it would make little sense to accomplish that objective by forcing new entrants, in the circumstances in which they are

entitled to lease elements, to pay whatever amount happens to appear on an incumbent's accounting books. That amount would vary widely and arbitrarily from incumbent to incumbent, and it could be higher or lower than the forward-looking economic costs of the elements at issue. See U.S. Pet. 6-8; see also U.S. Pet. App. 86a-87a. The FCC's decision to reject that approach was eminently reasonable, and it is entitled to substantial deference. See *Iowa Utils. Bd. I*, 525 U.S. at 397.

Verizon's policy concerns are, moreover, refuted by industry developments over the past four years. Since 1996, network element rates have reflected forward-looking cost principles. See U.S. Pet. 20-21. And, both before and after this Court's decision in *Iowa Utilities Board I*, new entrants have been able in many contexts to lease most of the elements necessary to provide service to their customers (as some of them must to develop a customer base sufficient to support further capital investments).[9] That established regulatory regime has not produced a "rapid proliferation" of "Potemkin village" competition. Indeed, in many settings, extensive competition has yet to develop; incumbents still control approximately 94% of total local telecommunications revenues (see *id.* at 2), and much of the existing competition in local markets, particularly in business markets, is provided by carriers that have built or purchased facilities of their own. In addition, new entrants have strong inherent incentives to build

---

[9] See generally Third Report and Order, *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 F.C.C.R. 3696 (1999), petitions for review filed *sub nom. United States Telecom Ass'n* v. *FCC*, Nos. 00-1015 and 00-1025.

their own facilities so as to avoid having to deal with and rely on their chief competitors—the incumbent LECs—in order to do business.

We will address those issues in greater detail in our brief on the merits if certiorari is granted. We acknowledge that, as Verizon observes (Pet. 20 n.7), the issue presented in Verizon's petition is closely related to the first issue presented in our petition. For that reason, even though Verizon's claim is substantively unsound, we do not oppose Verizon's petition so long as ours is granted.

2. a. We agree with petitioners AT&T (Pet. 16-21) and GCI (Pet. 7-29) that the Eighth Circuit erred in invalidating the FCC's rules implementing the "exemption," "suspension," and "modification" provisions of Section 251(f) for rural and small LECs.

First, in vacating the FCC's construction of the "undue economic burden" that would enable such carriers to avoid the obligations imposed by Section 251(c), the court of appeals attacked a straw man. The FCC did not, as the Eighth Circuit believed, "eliminat[e]" from the analysis any consideration of the "economic burden that is typically associated with efficient competitive entry." AT&T Pet. App. 29a. Although the FCC determined that such a burden is not, in itself, *sufficient* to satisfy the statutory standard for an exemption, suspension, or modification, the FCC did not suggest that such a burden is *irrelevant* to the analysis. Instead, the FCC provided that a carrier must demonstrate some economic burden "beyond"—*i.e.*, in addition to—an "economic burden that is typically associated with efficient competitive entry." 47 C.F.R. 51.405(c) and (d); see AT&T Pet. App. 193a, 196a-197a.

Because the Eighth Circuit misunderstood that point, it is unclear whether the court meant to invalidate the

approach that the FCC actually chose. If the decision below were construed to do so, it could significantly impede the development of local competition in many rural areas, because the introduction of competition inherently imposes an economic burden on a monopolist. See AT&T Pet. 17-19. Granting certiorari to review the Eighth Circuit's invalidation of 47 C.F.R. 51.405, as AT&T and GCI urge, would spare the industry another round of lower-court litigation on that point.[10]

Second, the court of appeals also erred in invalidating the FCC's determination with respect to the burden of proof in proceedings under Section 251(f)(1). As the FCC explained (AT&T Pet. App. 193a-194a), Section 251(f)(1) is most sensibly effectuated by imposing the burden on the LEC resisting the otherwise generally applicable obligations of Section 251(c). Among other considerations, that carrier has control of most of the relevant information. It would make little sense to expect a new entrant to bear the burden of proving, for example, that an incumbent would *not* suffer an "undue economic burden." See generally GCI Pet. 12-18; cf. *NLRB* v. *Transportation Mgmt. Corp.*, 462 U.S. 393, 403 (1983) (upholding agency's reasonable allocation of burden of proof).

---

[10] As noted above, the Eighth Circuit invalidated 47 C.F.R. 51.405(c) on the additional ground that the rule, in isolation, could be read to imply that a state commission may disregard "two of the three statutory requirements that must be met before a state commission can terminate an exemption." AT&T Pet. App. 27a. Because (as the Eighth Circuit understood, see *ibid.*) the FCC has clarified that the rule should not be so construed, the Eighth Circuit's ruling on this point has no substantive significance and poses no obstacle to this Court's review of the question presented by AT&T and GCI.

Nothing in Section 251(f)(1) can plausibly be said to point in the *opposite* direction, although the court of appeals erroneously believed otherwise. Indeed, the court held that the "plain meaning of the statute" (AT&T Pet. App. 32a) forecloses the FCC's determination under the first step of the analysis set forth in *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-843 (1984). The basis for that holding is obscure. The court appeared to rely on language in Section 251(f)(1)(A) providing that "the requirements of § 251(c) 'shall not apply to a rural telephone company *until*' a request has been made." AT&T Pet. App. 31a (quoting 47 U.S.C. 251(f)(1)(A)); but cf. 47 U.S.C. 251(f)(1)(B) (providing that, within 120 days of filing of request, "the State Commission *shall terminate* the exemption" unless certain showings are made) (emphasis added). But that fact, as well as the court's related point that Section 251(f)(1) addresses proceedings involving termination (rather than grants) of exemptions (AT&T Pet. App. 32a), is logically irrelevant to whether the incumbent should bear the burden of proof in such proceedings once a party challenges the exemption. See AT&T Pet. 20 & n.7. The court's apparent assumption to the contrary, which constitutes the whole of its analysis on the burden-of-proof issue, is plainly wrong.

b. We also agree with petitioners AT&T and WorldCom that the court of appeals erred in invalidating the FCC's rules governing the "wholesale rates" that an incumbent may charge new entrants that seek to purchase its services for resale to subscribers.

Section 252(d)(3) provides that "wholesale rates" for resellers shall be based on retail rates that an incumbent charges to its subscribers, "excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." The Eighth Circuit construed Section 252(d)(3) to compel an approach under which the only costs that may be excluded from retail rates are those that "will be avoided *by selling to the competitor the services it requests*." AT&T Pet. App. 18a (emphasis added). The emphasized language, however, does not appear in the 1996 Act. Although the Act speaks of costs that "will be avoided," it contains a critical gap: It does not identify *what*, for statutory purposes, causes costs to be "avoided." The FCC reasonably filled that gap by construing Section 252(d)(3) to encompass the costs that "will be avoided" as the result of treating the incumbent as a wholesaler rather than a retailer by excluding its retail-oriented costs. See AT&T Pet. App. 168a ("[T]he avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers.").

That approach is sensible. If resale is to be a workable means of entry into local telecommunications markets, a reseller cannot be expected to pay—in addition to its *own* retail costs and the incumbent's wholesale costs—a share of the *incumbent's* retail costs as well. See AT&T Pet. 21-24; see also AT&T Pet. App. 168a-170a. But the apparent consequence of the Eighth Circuit's decision is to undermine the competitive position of resellers by requiring them to underwrite a substantial portion of the incumbent's retail costs as well as their own. Moreover, as petitioner WorldCom points out (Pet. 27), the Eighth Circuit's approach gives incumbents artificial inducements to defeat resale-based competition by unreasonably refusing to "avoid[]" costs of services that they provide to new entrants for resale. Unless reversed, therefore, the

Eighth Circuit's holding threatens to read resale out of the 1996 Act as an option for entry into local telecommunications markets.

c. Although we believe that the Eighth Circuit was wrong on the merits in invalidating the FCC's rules concerning exemptions, suspensions, and modifications under Section 251(f) and wholesale rates under Section 252(d)(3), we did not challenge those holdings in our own petition for a writ of certiorari. Our petition is limited to two questions on which, in our view, this Court's review is most urgently needed: the validity of the FCC's cost methodology for determining the rates for network elements and interconnection, and the validity of the "combinations" rules set forth in 47 C.F.R. 51.315(c)-(f). Both of those issues have immense significance for the telecommunications industry. In addition, the first issue presents largely the same methodological dispute as did another case that the Court granted certiorari to review this Term,[11] and the second issue is the subject of an explicit circuit conflict.

The additional questions presented by petitioners in Nos. 00-555, 00-590, and 00-602, although somewhat less important than the questions presented in our petition, are also of considerable importance. The Court could appropriately review those questions as well, and, in our view, it would be particularly constructive for the Court to review the questions related to Section 251(f). We are concerned that, as petitioner GCI observes

[11] On November 2, 2000, this Court granted Verizon's unopposed motion to dismiss *GTE Serv. Corp.* v. *FCC*, No. 99-1244, in which one of Verizon's corporate predecessors (GTE) was the petitioner. See U.S. Pet. 22-25 (discussing similarity of the pricing methodologies at issue in both cases). As we will discuss in the reply brief supporting our own petition in No. 00-587, the dismissal of that case reinforces the need for this Court to grant our petition.

(Pet. 7), the Eighth Circuit's erroneous rulings concerning Section 251(f) could be construed to leave much of "rural and small town America" without the primary benefits of Section 251, a result that Congress plainly did not intend.

CONCLUSION

We do not oppose the petition for certiorari in No. 00-511 so long as the Court grants certiorari with respect to the first question presented in our petition in No. 00-587. We also do not oppose the petitions for certiorari in Nos. 00-555, 00-590, and 00-602.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

CHRISTOPHER J. WRIGHT
General Counsel
Federal Communications Commission

NOVEMBER 2000

Supreme Court, U.S.
FILED
NOV 17 2000
CLERK

(3)

No. 00-511

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,

v.

FCC, *et al.*
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONSE BRIEF OF WORLDCOM, INC., THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES, AND COMPETITIVE TELECOMMUNICATIONS ASSOCIATION

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.*
JODIE L. KELLEY
JENNER & BLOCK
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Respondent WorldCom, Inc.

November 17, 2000

* Counsel of Record

[*Additional Counsel Listed on Inside Cover*]

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

7RP

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCAL TELECOMMUNICATIONS
SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Respondent The Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE
TELECOMMUNICATIONS
ASSOCIATION
1900 M. Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Respondent Competitive Telecommunications Association

Respondents WorldCom, Inc., The Association for Local Telecommunications and Competitive Telecommunications Association respectfully submit this response to the Petition for a Writ of Certiorari to the Eighth Circuit Court of Appeals filed by Verizon Communications Inc. ("Verizon").

As this Court is aware, in 1996 Congress passed the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151-276 (the "1996 Act"), a landmark statute designed to make local telephone markets competitive "as quickly as possible." H.R. Rep. No. 104-204 at 89 (1995). Responding to Congress's mandate, the Federal Communications Commission ("FCC") issued comprehensive regulations to implement the Act within six months of its passage, releasing an order on August 8, 1996. *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499 (1996) ("*Local Competition Order*"). Petitions for review of that Order were consolidated in the Eighth Circuit, which stayed, and then vacated, a number of the FCC's regulations, including the FCC's pricing rules, primarily on the ground that the FCC lacked authority to promulgate them. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997). This Court reversed in part, reinstating, among others, the pricing regulations at issue. *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999).

On remand, the Eighth Circuit again invalidated several of the FCC's regulations – including one portion of the FCC's network element pricing rule.[1/] With respect to this pricing rule, the Eighth Circuit found that the term "cost" in

---

1/ In particular, the Eighth Circuit invalidated a key portion of the FCC's "TELRIC" rule, which sets rates for network elements at their forward-looking cost. As the FCC explained, forward-looking cost is the most appropriate measure of cost in this context, because forward-looking costs are the only costs relevant in a competitive market. *Local Competition Order* ¶ 675.

§ 252(d)(1) "is ambiguous" and that the FCC therefore had the authority to interpret the term to allow for a forward-looking cost model. Pet. App. 11a. The court further held that the FCC's "use of a forward-looking methodology was reasonable," noting that the FCC had explained "in detail its reasoning." Pet. App. 12a. The court also held that the doctrine of constitutional avoidance did not require the FCC to use a historical cost model, citing well established law that "a takings claim cannot be based on the ratemaking methodology but must be based on the rate itself." Pet. App. 17a.

The Eighth Circuit nevertheless invalidated a key portion of the FCC's TELRIC methodology. The court believed that the language of § 252(d)(1) – which mandates rates based on the "cost . . . of providing the . . . network element" – precluded a forward-looking cost methodology that calculates costs by reference to efficient technology and design choices. Pet. App. 9a-10a. The FCC, WorldCom, Inc., and AT&T Corp. have each filed petitions seeking review of, *inter alia*, the Eighth Circuit's decision invalidating this portion of the FCC's TELRIC pricing rule. *See WorldCom, Inc. v. Verizon Communications, Inc.*, No 00-555 (U.S. filed Oct. 10, 2000); *AT&T Corp. v. Iowa Utilities Board*, No. 00-590 (U.S. filed Oct. 13, 2000); *FCC v. Iowa Utilities Board*, No. 00-587 (U.S. filed Oct. 13, 2000).

Verizon's petition seeks review of a different portion of the Eighth Circuit's decision – that portion concluding that the incumbent LECs have not made out a takings claim. In particular, Verizon asserts that the statutory requirement that rates be based on "cost" must be construed to permit recovery of incumbent local exchange carriers' historical costs in order to avoid takings concerns. As the Eighth Circuit concluded, however, this claim cannot even be assessed because the incumbent LECs have provided absolutely no rate or revenue data. Nor could they. The FCC has expressly left it to the

states to adopt critical inputs – such as depreciation and cost of capital – and to set the actual rates for network elements. Thus, Verizon challenges *only* a rate methodology – a challenge which is squarely foreclosed by a half century of precedent. Moreover, the Just Compensation Clause requires compensation for the *value* of the property taken. TELRIC – which measures what it would cost a firm today to provide the same elements Verizon is producing – calculates precisely that value. TELRIC's "replacement cost" approach to valuation has always been a permissible way of valuing utility property.

That the takings issue is meritless is bolstered by the fact that each of the courts of appeals to have reviewed this issue has reached the same conclusion. *See Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393, 407 (5th Cir. 1999) (upholding against takings challenge the FCC's adoption of the TELRIC methodology to implement the Act's requirements with respect to universal service – the policy of assuring affordable quality local telephone service), *cert. granted sub nom, GTE Service Corp. v. FCC*, 120 S. Ct. 2214 (2000), *cert. dismissed*, No. 99-1244, 2000 WL 1641148 (U.S. Nov. 2, 2000). Although this Court granted GTE's petition for review of that decision, GTE voluntarily dismissed that case after opening and opposition briefs were filed. In this petition, Verizon asserts that "This Case Presents Virtually the Same Core Challenges as the Universal Service Case." Pet. at 15. The issues raised by Verizon have no more force here than they did in the case GTE has now abandoned.[2/]

2/ Indeed, this case presents an even poorer vehicle for assessing the constitutionality of rates produced by the TELRIC methodology than did the universal service case. In the universal service context, the FCC applied its methodology to calculate the costs of providing rural service and used those costs to calculate actual federal subsidy amounts that would be paid to Verizon and other carriers.

For all of these reasons, respondents believe there is more than ample basis to deny Verizon's petition. Respondents recognize, however, that the Solicitor General has indicated that he will not oppose Verizon's petition, and believe that it would be inappropriate for a private party to do so in these circumstances. Moreover, it is critical that the process of opening local markets to competition is not delayed further. Over four years after the FCC's rules issued, and almost five years after passage of the Act, the rules under which competition will emerge remain unsettled and competition remains stalled. The Eighth Circuit's invalidation of a portion of the FCC's rules on statutory grounds continues to inject debilitating uncertainty into attempts to open local markets to competition. Verizon's repeated constitutional challenges to those rules – though uniformly unsuccessful – have similarly slowed any meaningful shift to true competition. Accordingly, respondents do not object to review of *all* challenges to the FCC's pricing methodology, so that the validity of that methodology can be fully and finally resolved.

Respectfully submitted,

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.*
JODIE L. KELLEY
JENNER & BLOCK
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Respondent WorldCom, Inc.

* Counsel of Record

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCALTELECOMMUNICATIONS SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Respondent The Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE
TELECOMMUNICATIONS
ASSOCIATION
1900 M Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Respondent Competitive Telecommunications Association

(4)

No. 00-511

Supreme Court, U.S.
FILED
NOV 28 2000
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY TO BRIEFS IN RESPONSE

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., and United States Telecom Association

CHARLES R. MORGAN
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-4839

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON SERVICES GROUP
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

November 28, 2000

Additional Counsel Listed on Inside Cover

8pp

JAMES D. ELLIS
ALFRED G. RICHTER, JR.
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
HOPE E. THURROTT
CHARLES J. SCHARNBERG
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States
Telecom Association

No. 00-511

IN THE

Supreme Court of the United States

OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *et al.*,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY TO BRIEFS IN RESPONSE

The FCC and its supporters all agree that if the Court reviews the Eighth Circuit's rulings concerning the pricing standard for unbundled network elements at all, it should review *both* the claims raised in our petition *and* the pricing claims presented by the FCC and its supporters. As the FCC acknowledges, "the issue presented in Verizon's petition is closely related to the first issue presented in our petition." FCC Br. 16. The Court should review both sets of issues relating to the proper construction of the pricing standard in section

252(d)(1) of the Telecommunications Act – and only those issues.[1]

Our basic challenges to the FCC's TELRIC pricing methodology present the same fundamental issues that this Court already determined were worthy of review in *GTE Service Corp. v. FCC*, No. 99-1244 (the "Universal Service Case"). As explained in our Petition, the same fundamental constitutional principles that underpinned the challenges brought in the Universal Service Case also supply the critical backdrop for the statutory construction arguments in this case. *See* Pet. 14-19.

While the FCC and its supporters do not oppose our Petition, they do attack the merits of our claims. We will postpone a full discussion of the merits to later briefing in the event that the Court grants certiorari. A few points, however, are worth addressing here.

First, the FCC claims that any arguments based on takings principles have no merit because we have not shown that using TELRIC for network-element prices will "jeopardize the financial integrity" of incumbents and that, overall, incumbents have "enjoyed quite healthy returns in recent years." FCC Br. 11 (internal quotation marks omitted).[2] But

[1] As we have explained in our brief in opposition to the petitions in Nos. 00-555, 00-587, and 00-590, the issues raised in those petitions concerning the wholesale pricing standard for finished services and the non-pricing issues do not merit this Court's review.

[2] The FCC suggests in a footnote that we have not challenged the Eighth Circuit's ruling upholding the FCC's decision to exclude the costs of existing subsidy systems from the prices for network elements. *See* FCC Br. 9 n.4. That is mistaken. The question presented in our petition broadly draws into issue the FCC's decision to "prescrib[e] a pricing methodology that requires prices based solely on 'forward-looking' costs" and thus encompasses the FCC's decisions to exclude each of a number of other measures of cost. Pet. i. And in the body of our Petition, we made clear that our challenge specifically includes the FCC's decision "to exclude

these arguments are wholly misplaced. As explained in our Petition, under this Court's decision in *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396 (1920), a regulated entity cannot be forced to carry on a line of business at a loss on the expectation that it will make up the shortfall from competitive lines of business. *See* Pet. 17-18. The FCC's effort to dismiss any takings concerns with the glib observation that incumbents have been earning "healthy returns" thus ignores the proper application of *Brooks Scanlon* and the so-called "total effect" test of *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

Second, the FCC asserts that *Duquesne* does not hold that where a regulator switches rate methodologies, it must ensure that the new methodology continues to provide an adequate return on past investments as measured under the old methodology. *See* FCC Br. 12. But the FCC cannot dispute that this Court did, in fact, apply that analysis to decide *Duquesne*. Instead, the FCC simply asserts, without explanation, that the Court's stated analysis was a "sufficient" but not a "necessary" ground for decision. But as we will discuss more fully in our merits brief if the Court grants certiorari, the analysis applied in *Duquesne* was not simply some *ad hoc* rationale invented to dispose of a single case. Rather it was rooted in application of the fundamental principle that the government cannot induce investment under one set of rules and then change the rules in midstream in a way that appropriates value.

Third, apparently relying on the Eighth Circuit's suggestion that the consequences of using TELRIC "cannot be known until the resulting rates have been determined and applied," Pet. App. 18a, WorldCom asserts that our challenges cannot be evaluated because we have provided "no rate or

consideration of the very real costs that existing subsidy systems impose on incumbents." *Id.* at 20.

revenue data." WorldCom Br. 2. But as explained in our petition, the Eighth Circuit's "ripeness" analysis was flawed in several respects, not least because it ignored the fact that under *Duquesne* parties plainly may bring prospective challenges based on the projected effects of a rate methodology. And in any event, since we are not bringing a claim for compensation for a completed taking, we need not calculate the exact dollar amount of the confiscation that will be imposed by relying on TELRIC in order to demonstrate that the novel methodology raises serious takings concerns and that the Act should not be construed to permit it.

Finally, WorldCom attempts to portray the dismissal of the Universal Service Case as somehow indicating that substantive challenges to TELRIC lack merit. *See* WorldCom Br. 3. That is baseless. GTE moved to dismiss that case when the FCC, in its merits brief before this Court, for the first time disclaimed authority to dictate the methodology States must use in setting their universal service support mechanisms. That disclaimer established that TELRIC would not be the sole measure used to set the full compensation incumbents would receive for providing universal service. GTE determined, therefore, that the case no longer presented an appropriate vehicle for addressing challenges to TELRIC. Here, in contrast, there is no question that TELRIC sets the sole compensation incumbents will receive for turning over pieces of their networks to competitors. As explained in our Petition, for this and other reasons, this case presents the best vehicle for considering challenges to TELRIC. *See* Pet. 22-24.[3]

[3] WorldCom's effort to claim now that this case somehow provides an "even poorer vehicle" for addressing the FCC's TELRIC methodology, WorldCom Br. 3 n.2, makes no sense. In the Universal Service Case, WorldCom claimed that the Court would not be able to address challenges to TELRIC at all because TELRIC would not be used to determine the full amount of the subsidy that carriers would receive for providing universal service. In this case, in contrast, as we have already pointed out, TELRIC is used to determine the entire compensation incumbents receive for turning over access to elements of their networks, and state commissions have already applied the methodology to set actual prices in dozens of proceedings. Pet. 18.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for
BellSouth Corporation,
SBC Communications Inc.,
and United States Telecom
Association

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON SERVICE
CORPORATION
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
STEVEN G. BRADBURY
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Verizon Entities

CHARLES R. MORGAN
M. ROBERT SUTHERLAND
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-4839

Counsel for
BellSouth Corporation

JAMES D. ELLIS
ALFRED G. RICHTER, JR.
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
HOPE E. THURROTT
CHARLES J. SCHARNBERG
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States
Telecom Association

November 28, 2000

(10) (10) (9) (10) (10)

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

Supreme Court, U.S.
FILED
AUG 6 2001
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA, *ET AL.*,
Respondents.

On Writs of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

JOINT APPENDIX
VOLUME I

MARK L. EVANS
MICHAEL K. KELLOGG
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for Petitioners BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Petitioners Verizon Entities

Additional Counsel Listed on Inside Cover

00-511 PETITION FOR CERTIORARI FILED SEPTEMBER 4, 2000
00-555 PETITION FOR CERTIORARI FILED SEPTEMBER 10, 2000
00-587 PETITION FOR CERTIORARI FILED SEPTEMBER 13, 2000
00-590 PETITION FOR CERTIORARI FILED SEPTEMBER 13, 2000
00-602 PETITION FOR CERTIORARI FILED SEPTEMBER 16, 2000
CERTIORARI GRANTED JANUARY 22, 2001

510 pp

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING LLP
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 South Grand Avenue
Los Angeles, CA 90071
(213) 683-9100

Counsel for Petitioners
Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for Petitioner
BellSouth Corporation

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for Petitioner
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for Petitioner
United States Telecom
Association

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.
Counsel of Record
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Petitioner WorldCom, Inc.

JONATHAN M. ASKIN
THE ASSOCIATION FOR LOCAL
TELECOMMUNICATIONS
SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Petitioner The Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE
TELECOMMUNICATIONS
ASSOCIATION
1900 M Street, N.W.
Suite 800
Washington, D.C. 20036

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Petitioner Competitive Telecommunications Association

JOHN E. INGLE
LAWRENCE N. BOURNE
FEDERAL COMMUNICATIONS
COMMISSION
Washington, D.C. 20554

THEODORE B. OLSON
Solicitor General
Counsel of Record
DEPARTMENT OF JUSTICE
Washington, D.C. 20530
(202) 514-2217

Counsel for Petitioners Federal Communications Commission and the United States of America

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORPORATION
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER
Counsel of Record
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY, AUSTIN, BROWN & WOOD
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner AT&T Corporation

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent Sprint Corporation

IRWIN A. POPOWSKY
Counsel of Record
PHILLIP F. MCLELLAND
JOEL H. CHESKIS
NASUCA
c/o Pennsylvania Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101
(717) 783-5048

Counsel for Respondent National Association of State Utility Consumer Advocates

LAWRENCE G. MALONE
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK
Three Empire State Plaza
Albany, NY 12223
(518) 474-2510

JAMES BRADFORD RAMSEY
Counsel of Record
SHARLA BARKLIND
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
1101 Vermont Ave., N.W.
#200
Washington, D.C. 20005
(202) 898-2207

Counsel for Respondents Public Service Commission of the State of New York and National Association of Regulatory Utility Commissioners

TABLE OF CONTENTS

VOLUME I

Federal Communications Commission
Relevant Docket Entries 1

United States Court of Appeals for the Eighth Circuit
Relevant Docket Entries 2

STATUTES & REGULATIONS

47 U.S.C. § 153(29) 9
47 U.S.C. § 201(b) 10
47 U.S.C. § 251 11
47 U.S.C. § 252 20
47 U.S.C. § 254 29

47 C.F.R. § 51.315 49
47 C.F.R. § 51.501 50
47 C.F.R. § 51.503 50
47 C.F.R. § 51.505 51
47 C.F.R. § 51.507 53
47 C.F.R. § 51.509 54
47 C.F.R. § 51.511 55

ADMINISTRATIVE MATERIALS

Comments of the Arizona Corporation Commission (May 16, 1996), pp. 11-12 57

Comments of AT&T Corp. (May 16, 1996), Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig 58

Comments of Bell Atlantic (May 16, 1996) Declaration of Robert W. Crandall, pp. 2, 6-10 83

Affidavit of Professor Jerry A. Hausman,
pp. 1-3, 6-8 89

Comments of the People of the State of California and the Public Utilities Commission of the State of California (May 16, 1996),
pp. 28-29 96

Comments of Connecticut Department of Public Utility Control (May 16, 1996),
Attachment C, pp. 9-10 98

Comments of GTE (May 16, 1996),
Affidavit of Edward C. Beauvais, Ph.D,
pp. 2-8. 103

Initial Comments of the Public Utilities Commission of Ohio (Phase I)(May 16, 1996),
p. 47 113

Comments of the Public Utility Commission of Texas (May 16, 1996),
¶ 45 115

Comments of the United States Telephone Association (May 16, 1996),
pp. 40-56 116

Comments of US WEST, Inc. (May 16, 1996),
Robert G. Harris and Dennis A. Yao,
Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange,
pp. 1-6 131

TABLE OF CONTENTS - Continued

Reply Comments of AT&T Corp. (May 30, 1996),
Reply Affidavit of William J. Baumol,
Janusz A. Ordover, and Robert D. Willig 140

Affidavit of Lee Selwin & Patricia Kravtin
pp. 2-3 149

Reply Comments of Bell Atlantic (May 30, 1996),
Declaration of Alfred E. Khan
and Timothy J. Tardiff,
¶¶ 4-29 152

Reply Comments of Cox Communications, Inc. (May 30, 1996),
p. 27 171

Reply Comments of National Telecommunications and Information Administration (May 30, 1996),
pp. 14-34 173

Reply Comments of United States Telecom Association (May 30, 1996),
Reply Affidavit of Professor
Jerry A. Hausman,
pp. 5-6, 8-11 195

Reply Comment of US WEST, Inc.(May 30, 1996),
Reply Affidavit of Robert G. Harris,
pp. 5-12 203

R. Glenn Hubbard & William H. Lehr, *Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman* (attached to Ex parte letter from Richard N. Clarke, AT&T, to William F. Caton, Secretary, FCC, CC Docket No. 96-98, July 19, 1996) 215

Kenneth C. Baseman *et al.*, *Depreciation and Capital Recovery Issues, A Response to Professor Hausman*, MICRA (July 24, 1996) (attached to Ex parte letter from Leonard Sawicki, MCI Telecommunications to William Caton, Secretary, FCC, CC Docket No. 96-98, July 24, 1996). 240

Excerpts from *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15,499 (1996).

¶¶ 1 - 15 264
¶ 29 273
¶ 86 274
¶ 123 275
¶ 176 276
¶¶ 217 - 218 277
¶¶ 258 - 270 278
¶¶ 277 - 288 287
¶¶ 292 - 297 295
¶¶ 307 - 314 299
¶ 329 306
¶¶ 332 - 333 307
¶¶ 377 - 396 308
¶ 412 323
¶¶ 618 - 740 325
¶¶ 764 - 765 424
¶¶ 790-798 425
¶ 835 433
¶¶ 859 - 862 ..... [illegible]
¶ 875 436
¶¶ 907 - 908 437
¶ 915 438
¶ 965 439
¶ 1054 439
¶ 1056 440
¶ 1065 441
Statement of Comm'r Chong 443

MISCELLANEOUS

Supplemental Affidavit of Dennis R. Trimble, In Appendix to GTE Service Corp.'s Motion For Stay Pending Judicial Review and For Expedited Judicial Review, *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) (No. 96-3321) 453

Transcript, "AT&T Investment Community Meeting" (Mar. 3, 1997) 464

VOLUME II

In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Report & Order, 11 F.C.C.R. 15,499 (1996) 500

TABLE OF CONTENTS - Continued

NOTICE

The following document has been omitted in the printing of Volume I of this Appendix. It may be found in Appendix A to Verizon Communications Inc.'s Petition for Writ of Certiorari at the following pages:

Opinion, *Iowa Utilities Board v. FCC*,
219 F.3d 744 (8th Cir. July 18, 2000) 1a-43a

FEDERAL COMMUNICATIONS COMMISSION

No. 96-98
IMPLEMENTATION OF THE LOCAL COMPETITION PROVISIONS OF THE TELECOMMUNICATIONS ACT OF 1996

RELEVANT DOCKET ENTRIES

Date	Proceedings
04/19/1996	DOC TYPE: NPRM APPL: COMMON CARRIER BUREAU LAW FIRM: FCC RELEASE/DENIED
08/01/1996	DOC TYPE: R&O APPL: COMMON CARRIER BUREAU LAW FIRM: FCC RELEASE/DENIED: 08/08/96 FCC/DA#: 96-325

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 96-3321

IOWA UTILITIES BOARD

v.

FCC

RELEVANT DOCKET ENTRIES

Date	Proceedings
9/6/96	PETITION for Review of an order of the FCC
9/13/96	Consolidation Order issued by Judicial Panel on Multidistrict Litigation: Eighth Circuit designated to hear petitions for review from the District of Columbia, Second, Fifth, Sixth and Eighth Circuits.
1/17/97	ARGUED AND SUBMITTED IN ST. LOUIS TO JUDGES Pasco M. Bowman, Circuit Judge, Roger L. Wollman, Circuit Judge, David R. Hansen, Circuit Judge.

Date	Proceedings
7/18/97	THE COURT: Pasco M. Bowman, Roger L. Wollman, David R. Hansen. OPINION FILED by David R. Hansen PUBLISHED [96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3519, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [878357] (ema) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3519 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]
7/18/97	JUDGMENT: Pasco M. Bowman, Roger L. Wollman, David R. Hansen: The order of the FCC is AFFIRMED, and VACATED in accordance with the opinion.[96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3519, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [878360] (ema) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-345[illegible]6-3453 96-3460 96-3507 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]

Date	Proceedings
2/25/99	Notification from Supreme Court stating that they had entered an order granting Supreme Court notice for certiorari (no paper document received, ruling on pending certs filed) [946067-1] [96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3519, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982, 96-4080, 96-4082, 96-4083] [1188976] Supreme Court notice for certiorari [946075-1] [1188976] granting Supreme Court notice for certiorari [946086-1] [1188976] granting Supreme Court notice for certiorari [927038-1] [1188976] granting Supreme Court notice for certiorari [927052-1] [1188976] granting Supreme Court notice for certiorari [927056-1] [1188976] granting Supreme Court notice for certiorari [927061-1] [1188976] (cmw) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3519 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982 96-4080 96-4082 96-4083]

Date	Proceedings
3/1/99	U.S. Supreme Court judgment filed: The judgment of July 18, 1997, is reversed in part and affirmed in part; the judgment of August 22, 1997, is reversed in part; and the cases are remanded to the United States Court of Appeals for Eighth Circuit for further proceedings in conformity with the opinion of this Court. It is further ordered that AT&T Corp., et al., recover from Iowa Utilities Board, et al., and California, et al., $300.00; MCI Telecommunications Corp. recover from Iowa Utilities Board, et al., and California, et al., $20,024.49; Assn. for Local Telecommunications Services, et al., recover from Iowa Utilities Board, et al., $300.00; Ameritech Corp., et al., recover from FCC, et al., $300.00; GTE Midwest, Inc., recover from FCC, et al. $300.00; US West, Inc., recover from FCC, et al., $300.00; and Southern New England Telephone Company, et al., recover from FCC $300.00 for costs herein expended. Filed in the Supreme Court on January 25, 1999.[96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3519, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [1101417] (mjh) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3519 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]

Date	Proceedings
6/10/99	JUDGE ORDER: In accordance with the Supreme Court's decision in AT&T Corp. v. Iowa Utilities Board, this court's judgment of July 18, 1997, and October 14, 1997, is vacated in part reinstating selected FCC rules. The remaining issues are to be argued Friday, September 17, 1999, in St. Louis, Missouri. A supplemental briefing is as follows: July 16, 1999, Petitioners and Supporting Intervenors' briefs due; August 16, 1999, FCC & United States brief due. Supplemental briefs limited to 28,000 words; reply briefs limited to 14,000 word. [96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [1142947] (mjh) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]

Date	Proceedings
9/17/99	ARGUED AND SUBMITTED IN ST. LOUIS TO JUDGES Roger L. Wollman, Circuit Judge, Pasco M. Bowman, Circuit Judge, David R. Hansen, Circuit Judge. William P. Barr for Petitioners on Appeal Regional Bell & GTE in 96-3321+. Maureen Mahoney for Petitioners U.S. Telephone Assoc., et al., in 96-3321+. Christopher Wright for Respondents on Appeal FCC in 96-3321+. Donald B. Verrilli for Intervenors on Appeal MCI in 96-3321+. Rebuttal by: William Barr and Maureen Mahoney. RECORDED.[96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] (kms) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]
7/18/00	THE COURT: Roger L. Wollman, Pasco M. Bowman, David R. Hansen. OPINION FILED by David R. Hansen PUBLISHED .[96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [1291785] (kas) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]

Date	Proceedings
7/18/00	JUDGMENT: Roger L. Wollman, Pasco M. Bowman, David R. Hansen It is hereby ordered and adjudged that petitions for review are granted in part, and that the FCC rules 47 C.F.R. Sections 51.505(b)(1), 51.609, 51.513, 51.611, 51.707, 51.317, 51.405(a),(c), and (d), and 51.303 are vacated. The court reaffirms its previous decision to vacate FCC rules 47 C.F.R. Sections 51.305(a)(4), 51.311(c), and 51.315(c)-(f). In all other respects, the petitions for review are denied.96-3321, 96-3406, 96-3410, 96-3414, 96-3416, 96-3418, 96-3424, 96-3430, 96-3436, 96-3444, 96-3450, 96-3453, 96-3460, 96-3507, 96-3520, 96-3603, 96-3608, 96-3696, 96-3708, 96-3709, 96-3756, 96-3901, 96-3906, 96-3982] [1291794] (kas) [96-3321 96-3406 96-3410 96-3414 96-3416 96-3418 96-3424 96-3430 96-3436 96-3444 96-3450 96-3453 96-3460 96-3507 96-3520 96-3603 96-3608 96-3696 96-3708 96-3709 96-3756 96-3901 96-3906 96-3982]

47 U.S.C. § 153

§ 153. Definitions

* * *

(29) Network element

The term "network element" means a facility or equipment used in the provision of a telecommunications service. Such term also includes features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service.

47 U.S.C. § 201

§ 201. Service and Charges

* * *

(b) All charges, practices, classifications, and regulations for and in connection with such communication service, shall be just and reasonable, and any such charge, practice, classification, or regulation that is unjust or unreasonable is declared to be unlawful: Provided, That communications by wire or radio subject to this chapter may be classified into day, night, repeated, unrepeated, letter, commercial, press, Government, and such other classes as the Commission may decide to be just and reasonable, and different charges may be made for the different classes of communications: Provided further, That nothing in this chapter or in any other provision of law shall be construed to prevent a common carrier subject to this chapter from entering into or operating under any contract with any common carrier not subject to this chapter, for the exchange of their services, if the Commission is of the opinion that such contract is not contrary to the public interest: Provided further, That nothing in this chapter or in any other provision of law shall prevent a common carrier subject to this chapter from furnishing reports of positions of ships at sea to newspapers of general circulation, either at a nominal charge or without charge, provided the name of such common carrier is displayed along with such ship position reports. The Commission may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this chapter.

47 U.S.C. § 251

§ 251. Interconnection

(a) General duty of telecommunications carriers - Each telecommunications carrier has the duty--

(1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and

(2) not to install network features, functions, or capabilities that do not comply with the guidelines and standards established pursuant to section 255 or 256 of this title.

(b) Obligations of all local exchange carriers - Each local exchange carrier has the following duties:

(1) Resale - The duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services.

(2) Number portability - The duty to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission.

(3) Dialing parity - The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

(4) Access to rights-of-way - The duty to afford access to the poles, ducts, conduits, and rights-of-way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224 of this title.

(5) Reciprocal compensation - The duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

(c) Additional obligations of incumbent local exchange carriers - In addition to the duties contained in subsection (b) of this section, each incumbent local exchange carrier has the following duties:

(1) Duty to negotiate - The duty to negotiate in good faith in accordance with section 252 of this title the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) of this section and this subsection. The requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements.

(2) Interconnection - The duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network–

(A) for the transmission and routing of telephone exchange service and exchange access;

(B) at any technically feasible point within the carrier's network;

(C) that is at least equal in quality to that provided by the local exchange carrier to itself or to any

subsidiary, affiliate, or any other party to which the carrier provides interconnection; and

(D) on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 of this title.

(3) Unbundled access - The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252 of this title. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

(4) Resale - The duty--

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

(5) Notice of changes - The duty to provide reasonable public notice of changes in the information necessary for the transmission and routing of services using that local exchange carrier's facilities or networks, as well as of any other changes that would affect the interoperability of those facilities and networks.

(6) Collocation - The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

(d) Implementation -

(1) In general - Within 6 months after February 8, 1996, the Commission shall complete all actions necessary to establish regulations to implement the requirements of this section.

(2) Access standards - In determining what network elements should be made available for purposes of subsection (c)(3) of this section, the Commission shall consider, at a minimum, whether--

(A) access to such network elements as are proprietary in nature is necessary; and

(B) the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.

(3) Preservation of State access regulations - In prescribing and enforcing regulations to implement the requirements of this section, the Commission shall not preclude the enforcement of any regulation, order, or policy of a State commission that--

(A) establishes access and interconnection obligations of local exchange carriers;

(B) is consistent with the requirements of this section; and

(C) does not substantially prevent implementation of the requirements of this section and the purposes of this part.

(e) Numbering administration -

(1) Commission authority and jurisdiction - The Commission shall create or designate one or more impartial entities to administer telecommunications numbering and to make such numbers available on an equitable basis. The Commission shall have exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States. Nothing in this paragraph shall preclude the Commission from delegating to State commissions or other entities all or any portion of such jurisdiction.

(2) Costs - The cost of establishing telecommunications numbering administration arrangements and number portability shall be borne by all telecommunications carriers on a competitively neutral basis as determined by the Commission.

(3) Universal emergency telephone number - The Commission and any agency or entity to which the Commission has delegated authority under this subsection shall designate 9-1-1 as the universal emergency telephone number within the

United States for reporting an emergency to appropriate authorities and requesting assistance. The designation shall apply to both wireline and wireless telephone service. In making the designation, the Commission (and any such agency or entity) shall provide appropriate transition periods for areas in which 9-1-1 is not in use as an emergency telephone number on October 26, 1999.

(f) Exemptions, suspensions, and modifications -

(1) Exemption for certain rural telephone companies -

(A) Exemption - Subsection (c) of this section shall not apply to a rural telephone company until (i) such company has received a bona fide request for interconnection, services, or network elements, and (ii) the State commission determines (under subparagraph (B)) that such request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 of this title (other than subsections (b)(7) and (c)(1)(D) thereof).

(B) State termination of exemption and implementation schedule - The party making a bona fide request of a rural telephone company for interconnection, services, or network elements shall submit a notice of its request to the State commission. The State commission shall conduct an inquiry for the purpose of determining whether to terminate the exemption under subparagraph (A). Within 120 days after the State commission receives notice of the request, the State commission shall terminate the exemption if the request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 of this title (other than subsections (b)(7) and (c)(1)(D) thereof). Upon termination of the exemption, a State commission shall establish an implementation schedule for compliance with the

request that is consistent in time and manner with Commission regulations.

(C) Limitation on exemption - The exemption provided by this paragraph shall not apply with respect to a request under subsection (c) of this section, from a cable operator providing video programming, and seeking to provide any telecommunications service, in the area in which the rural telephone company provides video programming. The limitation contained in this subparagraph shall not apply to a rural telephone company that is providing video programming on February 8, 1996.

(2) Suspensions and modifications for rural carriers - A local exchange carrier with fewer than 2 percent of the Nation's subscriber lines installed in the aggregate nationwide may petition a State commission for a suspension or modification of the application of a requirement or requirements of subsection (b) or (c) of this section to telephone exchange service facilities specified in such petition. The State commission shall grant such petition to the extent that, and for such duration as, the State commission determines that such suspension or modification--

(A) is necessary--

(i) to avoid a significant adverse economic impact on users of telecommunications services generally;

(ii) to avoid imposing a requirement that is unduly economically burdensome; or

(iii) to avoid imposing a requirement that is technically infeasible; and

(B) is consistent with the public interest, convenience, and necessity.

The State commission shall act upon any petition filed under this paragraph within 180 days after receiving such petition.

Pending such action, the State commission may suspend enforcement of the requirement or requirements to which the petition applies with respect to the petitioning carrier or carriers.

(g) Continued enforcement of exchange access and interconnection requirements - On and after February 8, 1996, each local exchange carrier, to the extent that it provides wireline services, shall provide exchange access, information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) that apply to such carrier on the date immediately preceding February 8, 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after February 8, 1996. During the period beginning on February 8, 1996 and until such restrictions and obligations are so superseded, such restrictions and obligations shall be enforceable in the same manner as
regulations of the Commission.

(h) Definition of incumbent local exchange carrier -

(1) Definition - For purposes of this section, the term 'incumbent local exchange carrier' means, with respect to an area, the local exchange carrier that--

(A) on February 8, 1996, provided telephone exchange service in such area; and

(B) (i) on February 8, 1996, was deemed to be a member of the exchange carrier association pursuant to

section 69.601(b) of the Commission's regulations (§ 47 C.F.R. 69.601(b)); or

(ii) is a person or entity that, on or after February 8, 1996, became a successor or assign of a member described in clause (i).

(2) Treatment of comparable carriers as incumbents - The Commission may, by rule, provide for the treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if--

(A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1);

(B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and

(C) such treatment is consistent with the public interest, convenience, and necessity and the purposes of this section.

(i) Savings provision - Nothing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201 of this title.

47 U.S.C. § 252

§ 252. Procedures for negotiation, arbitration, and approval of agreements

(a) Agreements arrived at through negotiation -

(1) Voluntary negotiations - Upon receiving a request for interconnection, services, or network elements pursuant to section 251 of this title, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251 of this title. The agreement shall include a detailed schedule of itemized charges for interconnection and each service or network element included in the agreement. The agreement, including any interconnection agreement negotiated before February 8, 1996, shall be submitted to the State commission under subsection (e) of this section.

(2) Mediation - Any party negotiating an agreement under this section may, at any point in the negotiation, ask a State commission to participate in the negotiation and to mediate any differences arising in the course of the negotiation.

(b) Agreements arrived at through compulsory arbitration -

(1) Arbitration - During the period from the 135th to the 160th day (inclusive) after the date on which an incumbent local exchange carrier receives a request for negotiation under this section, the carrier or any other party to the negotiation may petition a State commission to arbitrate any open issues.

(2) Duty of petitioner -

(A) A party that petitions a State commission under paragraph (1) shall, at the same time as it submits the petition, provide the State commission all relevant documentation concerning--

(i) the unresolved issues;

(ii) the position of each of the parties with respect to those issues; and

(iii) any other issue discussed and resolved by the parties.

(B) A party petitioning a State commission under paragraph (1) shall provide a copy of the petition and any documentation to the other party or parties not later than the day on which the State commission receives the petition.

(3) Opportunity to respond - A non-petitioning party to a negotiation under this section may respond to the other party's petition and provide such additional information as it wishes within 25 days after the State commission receives the petition.

(4) Action by State commission -

(A) The State commission shall limit its consideration of any petition under paragraph (1) (and any response thereto) to the issues set forth in the petition and in the response, if any, filed under paragraph (3).

(B) The State commission may require the petitioning party and the responding party to provide such information as may be necessary for the State commission to reach a decision on the unresolved issues. If any party refuses or fails unreasonably to respond on a timely basis to any reasonable request from the State commission, then the State commission may proceed on the basis of the best information available to it from whatever source derived.

(C) The State commission shall resolve each issue set forth in the petition and the response, if any, by

imposing appropriate conditions as required to implement subsection (c) of this section upon the parties to the agreement, and shall conclude the resolution of any unresolved issues not later than 9 months after the date on which the local exchange carrier received the request under this section.

(5) Refusal to negotiate - The refusal of any other party to the negotiation to participate further in the negotiations, to cooperate with the State commission in carrying out its function as an arbitrator, or to continue to negotiate in good faith in the presence, or with the assistance, of the State commission shall be considered a failure to negotiate in good faith.

(c) Standards for arbitration - In resolving by arbitration under subsection (b) of this section any open issues and imposing conditions upon the parties to the agreement, a State commission shall--

(1) ensure that such resolution and conditions meet the requirements of section 251 of this title, including the regulations prescribed by the Commission pursuant to section 251 of this title;

(2) establish any rates for interconnection, services, or network elements according to subsection (d) of this section; and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.

(d) Pricing standards -

(1) Interconnection and network element charges - Determinations by a State commission of the just and

reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section--

(A) shall be--

(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

(2) Charges for transport and termination of traffic -

(A) In general - For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5) of this title, a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless--

(i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

(ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls.

(B) Rules of construction - This paragraph shall not be construed--

(i) to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements); or

(ii) to authorize the Commission or any State commission to engage in any rate regulation proceeding

to establish with particularity the additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls.

(3) Wholesale prices for telecommunications services For the purposes of section 251(c)(4) of this title, a State commission shall determine wholesale rates on the basis of retail rates charges to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

(e) Approval by State commission -

(1) Approval required - Any interconnection agreement adopted by negotiation or arbitration shall be submitted for approval to the State commission. A State commission to which an agreement is submitted shall approve or reject the agreement, with written findings as to any deficiencies.

(2) Grounds for rejection - The State commission may only reject -

(A) an agreement (or any portion thereof) adopted by negotiation under subsection (a) of this section if it finds that--

(i) the agreement (or portion thereof) discriminates against a telecommunications carrier not a party to the agreement; or

(ii) the implementation of such agreement or portion is not consistent with the public interest, convenience, and necessity; or

(B) an agreement (or any portion thereof) adopted by arbitration under subsection (b) of this section if it

finds that the agreement does not meet the requirements of section 251 of this title, including the regulations prescribed by the Commission pursuant to section 251 of this title, or the standards set forth in subsection (d) of this section.

(3) Preservation of authority - Notwithstanding paragraph (2), but subject to section 253 of this title, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of an agreement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(4) Schedule for decision - If the State commission does not act to approve or reject the agreement within 90 days after submission by the parties of an agreement adopted by negotiation under subsection (a) of this section, or within 30 days after submission by the parties of an agreement adopted by arbitration under subsection (b) of this section, the agreement shall be deemed approved. No State court shall have jurisdiction to review the action of a State commission in approving or rejecting an agreement under this section.

(5) Commission to act if State will not act - If a State commission fails to act to carry out its responsibility under this section in any proceeding or other matter under this section, then the Commission shall issue an order preempting the State commission's jurisdiction of that proceeding or matter within 90 days after being notified (or taking notice) of such failure, and shall assume the responsibility of the State commission under this section with respect to the proceeding or matter and act for the State commission.

(6) Review of State commission actions - In a case in which a State fails to act as described in paragraph (5), the

proceeding by the Commission under such paragraph and any judicial review of the Commission's actions shall be the exclusive remedies for a State commission's failure to act. In any case in which a State commission makes a determination under this section, any party aggrieved by such determination may bring an action in an appropriate Federal district court to determine whether the agreement or statement meets the requirements of section 251 of this title and this section.

(f) Statements of generally available terms -

(1) In general - A Bell operating company may prepare and file with a State commission a statement of the terms and conditions that such company generally offers within that State to comply with the requirements of section 251 of this title and the regulations thereunder and the standards applicable under this section.

(2) State commission review - A State commission may not approve such statement unless such statement complies with subsection (d) of this section and section 251 of this title and the regulations thereunder. Except as provided in section 253 of this title, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of such statement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(3) Schedule for review - The State commission to which a statement is submitted shall, not later than 60 days after the date of such submission--

(A) complete the review of such statement under paragraph (2) (including any reconsideration thereof), unless the

submitting carrier agrees to an extension of the period for such review; or

(B) permit such statement to take effect.

(4) Authority to continue review - Paragraph (3) shall not preclude the State commission from continuing to review a statement that has been permitted to take effect under subparagraph (B) of such paragraph or from approving or disapproving such statement under paragraph (2).

(5) Duty to negotiate not affected - The submission or approval of a statement under this subsection shall not relieve a Bell operating company of its duty to negotiate the terms and conditions of an agreement under section 251 of this title.

(g) Consolidation of State proceedings - Where not inconsistent with the requirements of this chapter, a State commission may, to the extent practical, consolidate proceedings under sections 214(e), 251(f), and 253 of this title, and this section in order to reduce administrative burdens on telecommunications carriers, other parties to the proceedings, and the State commission in carrying out its responsibilities under this chapter.

(h) Filing required - A State commission shall make a copy of each agreement approved under subsection (e) of this section and each statement approved under subsection (f) of this section available for public inspection and copying within 10 days after the agreement or statement is approved. The State commission may charge a reasonable and nondiscriminatory fee to the parties to the agreement or to the party filing the statement to cover the costs of approving and filing such agreement or statement.

(i) Availability to other telecommunications carriers - A local exchange carrier shall make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.

(j) Definition of incumbent local exchange carrier - For purposes of this section, the term "incumbent local exchange carrier" has the meaning provided in section 251(h) of this title.

47 U.S.C. § 254

§ 254. Universal Service

(a) Procedures to review universal service requirements -

(1) Federal-State Joint Board on universal service - Within one month after February 8, 1996, the Commission shall institute and refer to a Federal-State Joint Board under section 410(c) of this title a proceeding to recommend changes to any of its regulations in order to implement sections 214(e) of this title and this section, including the definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for completion of such recommendations. In addition to the members of the Joint Board required under section 410(c) of this title, one member of such Joint Board shall be a State-appointed utility consumer advocate nominated by a national organization of State utility consumer advocates. The Joint Board shall, after notice and opportunity for public comment, make its recommendations to the Commission 9 months after February 8, 1996.

(2) Commission action - The Commission shall initiate a single proceeding to implement the recommendations from the Joint Board required by paragraph (1) and shall complete such proceeding within 15 months after February 8, 1996. The rules established by such proceeding shall include a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation. Thereafter, the Commission shall complete any proceeding to implement subsequent recommendations from any Joint Board on universal service within one year after receiving such recommendations.

(b) Universal service principles - The Joint Board and the Commission shall base policies for the preservation and advancement of universal service on the following principles:

(1) Quality and rates - Quality services should be available at just, reasonable, and affordable rates.

(2) Access to advanced services - Access to advanced telecommunications and information services should be provided in all regions of the Nation.

(3) Access in rural and high cost areas - Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

(4) Equitable and nondiscriminatory contributions - All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service.

(5) Specific and predictable support mechanisms - There should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service.

(6) Access to advanced telecommunications services for schools, health care, and libraries - Elementary and secondary schools and classrooms, health care providers, and libraries

should have access to advanced telecommunications services as described in subsection (h) of this section.

(7) Additional principles - Such other principles as the Joint Board and the Commission determine are necessary and appropriate for the protection of the public interest, convenience, and necessity and are consistent with this chapter.

(c) Definition

(1) In general - Universal service is an evolving level of telecommunications services that the Commission shall establish periodically under this section, taking into account advances in telecommunications and information technologies and services. The Joint Board in recommending, and the Commission in establishing, the definition of the services that are supported by Federal universal service support mechanisms shall consider the extent to which such telecommunications services--

(A) are essential to education, public health, or public safety;

(B) have, through the operation of market choices by customers, been subscribed to by a substantial majority of residential customers;

(C) are being deployed in public telecommunications networks by telecommunications carriers; and

(D) are consistent with the public interest, convenience, and necessity.

(2) Alterations and modifications - The Joint Board may, from time to time, recommend to the Commission

modifications in the definition of the services that are supported by Federal universal service support mechanisms.

(3) Special services - In addition to the services included in the definition of universal service under paragraph (1), the Commission may designate additional services for such support mechanisms for schools, libraries, and health care providers for the purposes of subsection (h) of this section.

(d) Telecommunications carrier contribution - Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service. The Commission may exempt a carrier or class of carriers from this requirement if the carrier's telecommunications activities are limited to such an extent that the level of such carrier's contribution to the preservation and advancement of universal service would be de minimis. Any other provider of interstate telecommunications may be required to contribute to the preservation and advancement of universal service if the public interest so requires.

(e) Universal service support - After the date on which Commission regulations implementing this section take effect, only an eligible telecommunications carrier designated under section 214(e) of this title shall be eligible to receive specific Federal universal service support. A carrier that receives such support shall use that support only for the provision, maintenance, and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purposes of this section.

(f) State authority - A State may adopt regulations not

inconsistent with the Commission's rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State. A State may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitions or standards that do not rely on or burden Federal universal service support mechanisms.

(g) Interexchange and interstate services - Within 6 months after February 8, 1996, the Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State.

(h) Telecommunications services for certain providers -

(1) In general -

(A) Health care providers for rural areas - A telecommunications carrier shall, upon receiving a bona fide request, provide telecommunications services which are necessary for the provision of health care services in a State, including instruction relating to such services, to any public or nonprofit health care provider that serves persons who reside in rural areas in that State at rates that are reasonably comparable

to rates charged for similar services in urban areas in that State. A telecommunications carrier providing service under this paragraph shall be entitled to have an amount equal to the difference, if any, between the rates for services provided to health care providers for rural areas in a State and the rates for similar services provided to other customers in comparable rural areas in that State treated as a service obligation as a part of its obligation to participate in the mechanisms to preserve and advance universal service.

(B) Educational providers and libraries - All telecommunications carriers serving a geographic area shall, upon a bona fide request for any of its services that are within the definition of universal service under subsection (c)(3) of this section, provide such services to elementary schools, secondary schools, and libraries for educational purposes at rates less than the amounts charged for similar services to other parties. The discount shall be an amount that the Commission, with respect to interstate services, and the States, with respect to intrastate services, determine is appropriate and necessary to ensure affordable access to and use of such services by such entities. A telecommunications carrier providing service under this paragraph shall--

(i) have an amount equal to the amount of the discount treated as an offset to its obligation to contribute to the mechanisms to preserve and advance universal service, or

(ii) notwithstanding the provisions of subsection (e) of this section, receive reimbursement utilizing the support mechanisms to preserve and advance universal service.

(2) Advanced services - The Commission shall establish competitively neutral rules--

(A) to enhance, to the extent technically feasible and economically reasonable, access to advanced telecommunications and information services for all public and nonprofit elementary and secondary school classrooms, health care providers, and libraries; and

(B) to define the circumstances under which a telecommunications carrier may be required to connect its network to such public institutional telecommunications users.

(3) Terms and conditions - Telecommunications services and network capacity provided to a public institutional telecommunications user under this subsection may not be sold, resold, or otherwise transferred by such user in consideration for money or any other thing of value.

(4) Eligibility of users - No entity listed in this subsection shall be entitled to preferential rates or treatment as required by this subsection, if such entity operates as a for-profit business, is a school described in paragraph (7)(A) with an endowment of more than $50,000,000, or is a library or library consortium not eligible for assistance from a State library administrative agency under the Library Services and Technology Act [20 U.S.C.A. §§ 9121 et seq.].

(5) Requirements for certain schools with computers having internet access -

(A) Internet safety -

(i) In general - Except as provided in clause (ii), an elementary or secondary school having computers with Internet access may not receive services at discount rates under paragraph (1)(B) unless the school, school board, local educational agency, or other authority with responsibility for administration of the school--

(I) submits to the Commission the certifications described in subparagraphs (B) and (C);

(II) submits to the Commission a certification that an Internet safety policy has been adopted and implemented for the school under subsection (l); and

(III) ensures the use of such computers in accordance with the certifications.

(ii) Applicability - The prohibition in clause (i) shall not apply with respect to a school that receives services at discount rates under paragraph (1)(B) only for purposes other than the provision of Internet access, Internet service, or internal connections.

(iii) Public notice; hearing - An elementary or secondary school described in clause (i), or the school board, local educational agency, or other authority with responsibility for administration of the school, shall provide reasonable public notice and hold at least one public hearing or meeting to address the proposed Internet safety policy. In the case of an elementary or secondary school other than an elementary or secondary school as defined in section 8801 of Title 20, the notice and hearing required by this clause may be limited to those members of the public with a relationship to the school.

(B) Certification with respect to minors - A certification under this subparagraph is a certification that the school, school board, local educational agency, or other authority with responsibility for administration of the school-

(i) is enforcing a policy of Internet safety for minors that includes monitoring the online activities of minors and the operation of a technology protection measure with respect to any of its computers with Internet access that protects against access through such computers to visual depictions that are--

(I) obscene;

(II) child pornography; or

(III) harmful to minors; and

(ii) is enforcing the operation of such technology protection measure during any use of such computers by minors.

(C) Certification with respect to adults - A certification under this paragraph is a certification that the school, school board, local educational agency, or other authority with responsibility for administration of the school-

(i) is enforcing a policy of Internet safety that includes the operation of a technology protection measure with respect to any of its computers with Internet access that protects against access through such computers to visual depictions that are--

(I) obscene; or

(II) child pornography; and

(ii) is enforcing the operation of such technology protection measure during any use of such computers.

(D) Disabling during adult use - An administrator, supervisor, or other person authorized by the certifying authority under subparagraph (A)(i) may disable the technology protection measure concerned, during use by an adult, to enable access for bona fide research or other lawful purpose.

(E) Timing of implementation -

(i) In general - Subject to clause (ii) in the case of any school covered by this paragraph as of the effective date of this paragraph under section 1721(h) of the Children's Internet Protection Act, the certification under subparagraphs (B) and (C) shall be made--

(I) with respect to the first program funding year under this subsection following such

effective date, not later than 120 days after the beginning of such program funding year; and

(II) with respect to any subsequent program funding year, as part of the application process for such program funding year.

(ii) Process -

(I) Schools with internet safety policy and technology protection measures in place - A school covered by clause (i) that has in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C) shall certify its compliance with subparagraphs (B) and (C) during each annual program application cycle under this subsection, execpt that with respect to the first program funding year after the effective date of this paragraph under section 1721(h) of the Children's Internet Protection Act, the certifications shall be made not later than 120 days after the beginning of such first program funding year.

(II) Schools without internet safety policy and technology protection measures in place - A school covered by clause (i) that does not have in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C)--

(aa) for the first program year after the effective date of this subsection in which it is applying for funds under this subsection, shall certify that it is undertaking such actions, including any necessary procurement procedures, to put in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C); and

(bb) for the second program year after the effective date of this subsection in which

it is applying for funds under this subsection, shall certify that it is in compliance with subparagraphs (B) and (C).

Any school that is unable to certify compliance with such requirements in such second program year shall be ineligible for services at discount rates or funding in lieu of services at such rates under this subsection for such second year and all subsequent program years under this subsection, until such time as such school comes into compliance with this paragraph.

(III) Waivers - Any school subject to subclause (II) that cannot come into compliance with subparagraphs (B) and (C) in such second year program may seek a waiver of subclause (II)(bb) if State or local procurement rules or regulations or competitive bidding requirements prevent the making of the certification otherwise required by such subclause. A school, school board, local educational agency, or other authority with responsibility for administration of the school shall notify the Commission of the applicability of such subclause to the school. Such notice shall certify that the school in question will be brought into compliance before the start of the third program year after the effective date of this subsection in which the school is applying for funds under this subsection.

(F) Noncompliance -

(i) Failure to submit certification - Any school that knowingly fails to comply with the application guidelines regarding the annual submission of certification required by this paragraph shall not be eligible for services at discount rates or funding in lieu of services at such rates under this subsection.

(ii) Failure to comply with certification - Any school that knowingly fails to ensure the use of its computers in accordance with a certification under

subparagraphs (B) and (C) shall reimburse any funds and discounts received under this subsection for the period covered by such certification.

(iii) Remedy of noncompliance -

(I) Failure to submit - A school that has failed to submit a certification under clause (i) may remedy the failure by submitting the certification to which the failure relates. Upon submittal of such certification, the school shall be eligible for services at discount rates under this subsection.

(II) Failure to comply - A school that has failed to comply with a certification as described in clause (ii) may remedy the failure by ensuring the use of its computers in accordance with such certification. Upon submittal to the Commission of a certification or other appropriate evidence of such remedy, the school shall be eligible for services at discount rates under this subsection.

(6) Requirements for certain libraries with computers having internet access -

(A) Internet safety -

(i) In general - Except as provided in clause (ii), a library having one or more computers with Internet access may not receive services at discount rates under paragraph (1)(B) unless the library--

(I) submits to the Commission the certifications described in subparagraphs (B) and (C); and

(II) submits to the Commission a certification that an Internet safety policy has been adopted and implemented for the library under subsection (l); and

(III) ensures the use of such computers in accordance with the certifications.

(ii) Applicability - The prohibition in clause (i) shall not apply with respect to a library that receives

services at discount rates under paragraph (1)(B) only for purposes other than the provision of Internet access, Internet service, or internal connections.

(iii) Public notice; hearing - A library described in clause (i) shall provide reasonable public notice and hold at least one public hearing or meeting to address the proposed Internet safety policy.

(B) Certification with respect to minors - A certification under this subparagraph is a certification that the library--

(i) is enforcing a policy of Internet safety that includes the operation of a technology protection measure with respect to any of its computers with Internet access that protects against access through such computers to visual depictions that are--

(I) obscene;

(II) child pornography; or

(III) harmful to minors; and

(ii) is enforcing the operation of such technology protection measure during any use of such computers by minors.

(C) Certification with respect to adults - A certification under this paragraph is a certification that the library--

(i) is enforcing a policy of Internet safety that includes the operation of a technology protection measure with respect to any of its computers with Internet access that protects against access through such computers to visual depictions that are--

(I) obscene; or

(II) child pornography; and

(ii) is enforcing the operation of such technology protection measure during any use of such computers.

(D) Disabling during adult use - An administrator, supervisor, or other person authorized by the certifying authority under subparagraph (A)(i) may disable the technology protection measure concerned, during use by an adult, to enable access for bona fide research or other lawful purpose.

(E) Timing of implementation -

(i) In general - Subject to clause (ii) in the case of any library covered by this paragraph as of the effective date of this paragraph under section 1721(h) of the Children's Internet Protection Act, the certification under subparagraphs (B) and (C) shall be made--

(I) with respect to the first program funding year under this subsection following such effective date, not later than 120 days after the beginning of such program funding year; and

(II) with respect to any subsequent program funding year, as part of the application process for such program funding year.

(ii) Process -

(I) Libraries with Internet safety policy and technology protection measures in place - A library covered by clause (i) that has in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C) shall certify its compliance with subparagraphs (B) and (C) during each annual program application cycle under this subsection, except that with respect to the first program funding year after the effective date of this paragraph under section 1721(h) of the Children's Internet Protection Act, the certifications shall be made not later than 120 days after the beginning of such first program funding year.

(II) Libraries without internet safety policy and technology protection measures in place - A

library covered by clause (i) that does not have in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C)--

(aa) for the first program year after the effective date of this subsection in which it is applying for funds under this subsection, shall certify that it is undertaking such actions, including any necessary procurement procedures, to put in place an Internet safety policy and technology protection measures meeting the requirements necessary for certification under subparagraphs (B) and (C); and

(bb) for the second program year after the effective date of this subsection in which it is applying for funds under this subsection, shall certify that it is in compliance with subparagraphs (B) and (C). Any library that is unable to certify compliance with such requirements in such second program year shall be ineligible for services at discount rates or funding in lieu of services at such rates under this subsection for such second year and all subsequent program years under this subsection, until such time as such library comes into compliance with this paragraph.

(III) Waivers - Any library subject to subclause (II) that cannot come into compliance with subparagraphs (B) and (C) in such second year may seek a waiver of subclause (II)(bb) if State or local procurement rules or regulations or competitive bidding requirements prevent the making of the certification otherwise required by such subclause. A library, library board, or other authority with responsibility for administration of the library shall notify the Commission of the applicability of such subclause to the library. Such notice shall certify that the library in question will be brought into compliance before the start of the third program year after the effective date of this subsection in which the library is applying for funds under this subsection.

(F) Noncompliance -

(i) Failure to submit certification - Any library that knowingly fails to comply with the application guidelines regarding the annual submission of certification required by this paragraph shall not be eligible for services at discount rates or funding in lieu of services at such rates under this subsection.

(ii) Failure to comply with certification - Any library that knowingly fails to ensure the use of its computers in accordance with a certification under subparagraphs (B) and (C) shall reimburse all funds and discounts received under this subsection for the period covered by such certification.

(iii) Remedy of noncompliance -

(I) Failure to submit - A library that has failed to submit a certification under clause (i) may remedy the failure by submitting the certification to which the failure relates. Upon submittal of such certification, the library shall be eligible for services at discount rates under this subsection.

(II) Failure to comply - A library that has failed to comply with a certification as described in clause (ii) may remedy the failure by ensuring the use of its computers in accordance with such certification. Upon submittal to the Commission of a certification or other appropriate evidence of such remedy, the library shall be eligible for services at discount rates under this subsection.

(7) Definitions - For purposes of this subsection:

(A) Elementary and secondary schools - The term "elementary and secondary schools" means elementary schools and secondary schools, as defined in paragraphs (14) and (25), respectively, of section 8801 of Title 20.

(B) Health care provider - The term "health care provider" means--

(i) post-secondary educational institutions offering health care instruction, teaching hospitals, and medical schools;

(ii) community health centers or health centers providing health care to migrants;

(iii) local health departments or agencies;

(iv) community mental health centers;

(v) not-for-profit hospitals;

(vi) rural health clinics; and

(vii) consortia of health care providers consisting of one or more entities described in clauses (i) through (vi).

(C) Public institutional telecommunications user - The term "public institutional telecommunications user" means an elementary or secondary school, a library, or a health care provider as those terms are defined in this paragraph.

(D) Minor - The term "minor" means any individual who has not attained the age of 17 years.

(E) Obscene - The term "obscene" has the meaning given such term in section 1460 of Title 18.

(F) Child pornography - The term "child pornography" has the meaning given such term in section 2256 of Title 18.

(G) Harmful to minors - The term "harmful to minors" means any picture, image, graphic image file, or other visual depiction that--

(i) taken as a whole and with respect to minors, appeals to a prurient interest in nudity, sex, or excretion;

(ii) depicts, describes, or represents, in a patently offensive way with respect to what is suitable for minors, an actual or simulated sexual act or sexual contact,

actual or simulated normal or perverted sexual acts, or a lewd exhibition of the genitals; and

(iii) taken as a whole, lacks serious literary, artistic, political, or scientific value as to minors.

(H) Sexual act; sexual contact - The terms "sexual act" and "sexual contact" have the meanings given such terms in section 2246 of Title 18.

(I) Technology protection measure - The term "technology protection measure" means a specific technology that blocks or filters Internet access to the material covered by a certification under paragraph (5) or (6) to which such certification relates.

(i) Consumer protection - The Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable.

(j) Lifeline assistance - Nothing in this section shall affect the collection, distribution, or administration of the Lifeline Assistance Program provided for by the Commission under regulations set forth in section 69.117 of title 47, Code of Federal Regulations, and other related sections of such title.

(k) Subsidy of competitive services prohibited - A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

(l) Internet safety policy requirement for schools and libraries

(1) In general - In carrying out its responsibilities under subsection (h), each school or library to which subsection (h) applies shall--

(A) adopt and implement an Internet safety policy that addresses--

(i) access by minors to inappropriate matter on the Internet and World Wide Web;

(ii) the safety and security of minors when using electronic mail, chat rooms, and other forms of direct electronic communications;

(iii) unauthorized access, including so-called "hacking", and other unlawful activities by minors online;

(iv) unauthorized disclosure, use, and dissemination of personal identification information regarding minors; and

(v) measures designed to restrict minors' access to materials harmful to minors; and

(B) provide reasonable public notice and hold at least one public hearing or meeting to address the proposed Internet safety policy.

(2) Local determination of content - A determination regarding what matter is inappropriate for minors shall be made by the school board, local educational agency, library, or other authority responsible for making the determination. No agency or instrumentality of the United States Government may--

(A) establish criteria for making such determination;

(B) review the determination made by the certifying school, school board, local educational agency, library, or other authority; or

(C) consider the criteria employed by the certifying school, school board, local educational agency, library, or other authority in the administration of subsection (h)(1)(B).

(3) Availability for review- Each Internet safety policy adopted under this subsection shall be made available to the Commission, upon request of the Commission, by the school, school board, local educational agency, library, or other authority responsible for adopting such Internet safety policy for purposes of the review of such Internet safety policy by the Commission.

(4) Effective date - This subsection shall apply with respect to schools and libraries on or after the date that is 120 days after Dec. 21, 2000.

47 C.F.R. § 51.315

§ 51.315 Combination of unbundled network elements.

(a) An incumbent LEC shall provide unbundled network elements in a manner that allows requesting telecommunications carriers to combine such network elements in order to provide a telecommunications service.
(b) Except upon request, an incumbent LEC shall not separate requested network elements that the incumbent LEC currently combines.
(c) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network, provided that such combination is:

(1) Technically feasible; and

(2) Would not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.

(d) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements with elements possessed by the requesting telecommunications carrier in any technically feasible manner.
(e) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(1) or paragraph (d) of this section must prove to the state commission that the requested combination is not technically feasible.
(f) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(2) of this section must prove to the state commission that the requested combination would impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.

* * *

47 C.F.R. §§ 51.501 - 51.511

§ 51.501 Scope.

(a) The rules in this subpart apply to the pricing of network elements, interconnection, and methods of obtaining access to unbundled elements, including physical collocation and virtual collocation.
(b) As used in this subpart, the term "element" includes network elements, interconnection, and methods of obtaining interconnection and access to unbundled elements.

§ 51.503 General pricing standard.

(a) An incumbent LEC shall offer elements to requesting telecommunications carriers at rates, terms, and conditions that are just, reasonable, and nondiscriminatory.
(b) An incumbent LEC's rates for each element it offers shall comply with the rate structure rules set forth in §§ 51.507 and 51.509, and shall be established, at the election of the state commission-

(1) Pursuant to the forward-looking economic cost-based pricing methodology set forth in §§ 51.505 and 51.511; or

(2) Consistent with the proxy ceilings and ranges set forth in § 51.513.

(c) The rates that an incumbent LEC assesses for elements shall not vary on the basis of the class of customers served by the requesting carrier, or on the type of services that the requesting carrier purchasing such elements uses them to provide.

§ 51.505 Forward-looking economic cost.

(a) In general. The forward-looking economic cost of an element equals the sum of:

(1) The total element long-run incremental cost of the element, as described in paragraph (b); and

(2) A reasonable allocation of forward-looking common costs, as described in paragraph (c).

(b) Total element long-run incremental cost. The total element long-run incremental cost of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(1) Efficient network configuration. The total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

(2) Forward-looking cost of capital. The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element.

(3) Depreciation rates. The depreciation rates used in calculating forward-looking economic costs of elements shall be economic depreciation rates.

(c) Reasonable allocation of forward-looking common costs--

(1) Forward-looking common costs. Forward-looking common costs are economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent LEC) that cannot be attributed directly to individual elements or services.

(2) Reasonable allocation.

(i) The sum of a reasonable allocation of forward-looking common costs and the total element long-run incremental cost of an element shall not exceed the stand-alone costs associated with the element. In this context, stand-alone costs are the total forward-looking costs, including corporate costs, that would be incurred to produce a given element if that element were provided by an efficient firm that produced nothing but the given element.

(ii) The sum of the allocation of forward-looking common costs for all elements and services shall equal the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LEC's total network, so as to provide all the elements and services offered.

(d) Factors that may not be considered. The following factors shall not be considered in a calculation of the forward- looking economic cost of an element:

(1) Embedded costs. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts;

(2) Retail costs. Retail costs include the costs of marketing, billing, collection, and other costs associated with offering retail telecommunications services to subscribers who are not telecommunications carriers, described in § 51.609;

(3) Opportunity costs. Opportunity costs include the revenues that the incumbent LEC would have received for the sale of telecommunications services, in the absence of competition from telecommunications carriers that purchase elements; and

(4) Revenues to subsidize other services. Revenues to subsidize other services include revenues associated with elements or telecommunications service offerings other than the element for which a rate is being established.

(e) Cost study requirements. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward- looking economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511.

(1) A state commission may set a rate outside the proxy ranges or above the proxy ceilings described in § 51.513 only if that commission has given full and fair effect to the economic cost based pricing methodology described in this section and § 51.511 in a state proceeding that meets the requirements of paragraph (e)(2) of this section.

(2) Any state proceeding conducted pursuant to this section shall provide notice and an opportunity for comment to affected parties and shall result in the creation of a written factual record that is sufficient for purposes of review. The record of any state proceeding in which a state commission considers a cost study for purposes of establishing rates under this section shall include any such cost study.

§ 51.507 General rate structure standard.

(a) Element rates shall be structured consistently with the manner in which the costs of providing the elements are incurred.

(b) The costs of dedicated facilities shall be recovered through flat-rated charges.

(c) The costs of shared facilities shall be recovered in a manner that efficiently apportions costs among users. Costs of shared facilities may be apportioned either through usage-sensitive charges or capacity-based flat-rated charges, if the state commission finds that such rates reasonably reflect the costs imposed by the various users.

(d) Recurring costs shall be recovered through recurring charges, unless an incumbent LEC proves to a state commission

that such recurring costs are de minimis. Recurring costs shall be considered de minimis when the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

(e) State commissions may, where reasonable, require incumbent LECs to recover nonrecurring costs through recurring charges over a reasonable period of time. Nonrecurring charges shall be allocated efficiently among requesting telecommunications carriers, and shall not permit an incumbent LEC to recover more than the total forward-looking economic cost of providing the applicable element.

(f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.

(1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in § 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.

(2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

§ 51.509 Rate structure standards for specific elements.

In addition to the general rules set forth in § 51.507, rates for specific elements shall comply with the following rate structure rules.

(a) Local loops. Loop costs shall be recovered through flat-rated charges.

(b) Local switching. Local switching costs shall be recovered through a combination of a flat-rated charge for line ports and one or more flat-rated or per-minute usage charges for the switching matrix and for trunk ports.

(c) Dedicated transmission links. Dedicated transmission link costs shall be recovered through flat-rated charges.

(d) Shared transmission facilities between tandem switches and end offices. The costs of shared transmission facilities between tandem switches and end offices may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.

(e) Tandem switching. Tandem switching costs may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.

(f) Signaling and call-related database services. Signaling and call-related database service costs shall be usage-sensitive, based on either the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, the cost of which shall be recovered through flat-rated charges.

(g) Collocation. Collocation costs shall be recovered consistent with the rate structure policies established in the Expanded Interconnection proceeding, CC Docket No. 91-141.

§ 51.511 Forward-looking economic cost per unit.

(a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.

(b)(1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the

discrete number of elements (e.g., local loops or local switch ports) that the incumbent LEC uses or provides.

(2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the unit of measurement of the usage (e.g., minutes of use or call-related database queries) of the element.

INITIAL COMMENTS OF THE ARIZONA CORPORATION COMMISSION

* * *

[*11*]

Finally, the Commission should be aware of the Arizona Commission's continuing commitment to the process of conducting an orderly transition towards a pro-competitive environment in the telecommunications industry in Arizona. The latest direct Arizona Commission initiative in this direction involves the activities surrounding adoption of proposed rules relating to Interconnection and Unbundling. On January 11, 1996, the Arizona Commission issued Decision [*12*] No. 59483, which approved and set for public hearing a Notice of Proposed Rulemaking relating to Telecommunications Interconnection and Unbundling (the Interconnection Rules). It is anticipated that the proposed rules will be adopted by the Arizona Commission on or before June 30, 1996. A copy of the Arizona Commission's proposed rules on Telecommunications Interconnection and Unbundling is attached to these Comments as Exhibit V. It is anticipated that the rules will be codified as A.A.C. R14-2-1301 et. seq., and they are so identified in the attached Exhibit. The Interconnection rules will govern interconnection requirements as provided in connection wih the Arizona Commission's general competition rules. The Interconnection Rules plainly fall within the ambit of § 251(d)(3) of the 1996 Act and are subject to preservation thereunder.

AFFIDAVIT OF WILLIAM J. BAUMOL, JANUSZ A. ORDOVER, AND ROBERT D. WILLIG

1. Our names are William J. Baumol, Janusz A. Ordover, and Robert D. Willig. William J. Baumol is Director of the C.V. Starr Center for Applied Economics at New York University and Professor Emeritus at Princeton University. His *curriculum vitae* appears as Attachment A. Janusz A. Ordover is Professor of Economics at New York University. His *curriculum vitae* appears as Attachment B. Robert D. Willig is Professor of Economics and Public Affairs at Princeton University. His *curriculum vitae* appears as Attachment C.

2. We submit this affidavit in response to the Commission's April 19, 1996 Notice of Proposed Rulemaking in CC Docket No. 96-98, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*. The Commission has proposed in its Notice to require ILECS (1) to offer unbundled network elements and interconnection services for sale to competitive local exchange carriers ("CLECS"), to the fullest practical extent, individually and in flexibly defined groups; (2) to price those network elements (as well as related interconnection and collocation) at competitive prices based on the economic costs of providing the network elements; and (3) to sell bundled services at wholesale to other carriers for resale. We applaud all three proposals.

3. Our focus in this affidavit is on the pricing of network elements. Adoption of economically defensible standards for pricing unbundled network elements is perhaps the single most critical aspect of the Commission's proposals. As we explain below, consistent with the competitive pricing contemplated by the Act, a defensible pricing standard must be based on forward-looking economic costs, not historic book costs, because the expansion, contraction, entry and exit decisions of competitors efficiently and necessarily turn on

expected prices and costs having nothing to do with costs expended historically or reflected on accounting books. [*2*] In the circumstances presented here, we conclude that the appropriate forward-looking benchmark for pricing is total service long run incremental cost, or TSLRIC. We further conclude that a cost model developed by Hatfield Associates, Inc. provides good empirical estimates of the TSLRIC of basic network elements.

4. Passage of the 1996 Telecommunications Act offers an invaluable opportunity to extend the benefits of competition to users of every product and segment of the industry, especially the local exchange, where competition has been least extensive and effective. Availability of unbundled network elements for sale at prices based on economic costs will foster efficient and prompt competition at all levels -- from resale alone at one end of the spectrum, to fully facilities-based at the other, and through the broad middle range of partially-facilities based competition. All of these forms of competition can benefit end users, bringing new vitality, innovation, pressures for cost-efficiency, and superior customer service to the market. But the fundamental policy of the 1996 Act -- extending all forms of competition to the markets where it is now absent -- cannot be attained unless the pricing principles discussed here are carried out. Misguided allegiance to prior regulatory norms or departure from the logic of free and competitive markets would frustrate the central goals of the act.

I. THE PROPER MEASURE OF THE ECONOMIC COST OF UNBUNDLED NETWORK ELEMENTS IS TOTAL SERVICE LONG RUN INCREMENTAL COST ("TSLRIC").

A. Pricing of Network Elements Should Be Based on Economic Costs, Not Book Costs.

5. Where, as here, markets are ineffectively competitive and regulatory oversight is warranted, regulators should set prices that replicate, as closely as possible, the prices that would prevail in competitive markets. Under this competitice standard, prices accomplish several crucial goals for economic efficiency and consumer benefits. First, prices should steer [*3*] purchasers to the most efficient, least-cost suppliers of each good or service for which there is sufficient demand. Second, prices should guide purchasers to make efficient choices among *different* goods and services offered in the market. Third, prices should achieve the level of cost recovery that encourages efficient levels of investment, entry and exit. These criteria dictate that network elements be priced on the basis of economic costs, not book or embedded costs.

6. Economic costs are calculated from the standpoint of building production and service capability *today*, at current input prices, and in the fashion that is most cost effective in light of today's available technology, input prices, and expectations about demand. For services that are not in decline, and that are expected to show demand sufficient for new and replacement investment, economic costs are long-run costs that reflect forward-looking efficient investment, including a return on capital consistent with competitive capital markets.

7. Both efficiency and the competitive model dictate this result. In competitive markets, efficient decisions about market entry, exit, expansion, and contraction are made by

comparing the anticipated revenue with the anticipated incremental costs of the contemplated change in output. Historical expenditures, and amount reflected on accounting books, are irrelevant to this calculus.

8. The basing of network element prices on book accounting costs, by contrast, would create new ILEC opportunities for inefficiency. If the network element prices were based on book accounting costs, then excess ILEC spending would be rewarded with the opportunity to recover the inefficient cost through higher prices. This outcome would sustain and restore one of the worst features of traditional public utlity regulation.

9. Further, basing network element prices on book accounting costs would give ILECs new opportunities to engage in anticompetitive strategic conduct by misallocating and [*4*] mischaracterizing costs. Misallocating book costs would enable ILECs to overprice the network elements purchased by rival carriers, thereby weakening or eliminating the competitive pressures for improved efficiency and service quality that the Act was intended to promote. Any costs shifted by the ILECs from the competitive activities to more-protected activities would permit them to raise network element prices in the more protected domain, while escaping the need to recover those costs from the competitive activities. In this way, ILECs would have a strong incentive to price the more competitive end-user services in a predatory fashion in order to build spending opportunities.

10. Finally, disparities between economic costs and prices for network elements would result in disparities between economic cost and prices for end-user services that use those network elements as inputs. The result could be long-lasting inefficiencies in the allocation of resources to telecommunications and related sectors such as computing and information services. Such an outcome would be especially

costly to society today, when fundamental decisions about the deployment and use of technology are up for grabs in the marketplace.

B. The Pertinent Measure of Economic Cost For Pricing Network Elements Is Incremental Cost.

11. The Measure of cost on which efficient prices are based, and to which efficient prices converge in competitive markets, is *incremental* cost. Incremental cost represents the *additional* cost to society of producing a particular network element or service, rather than the most valuable alternative use or uses, if all other outputs of the ILEC are held constant.[1]

[*5*] 12. Use of incremental cost pricing will best approximate the performance of competitive markets. In the long run, prices in competitive markets converge to incremental cost. Firms decide whether to expand or enter new markets by

[1] Another important measure of economic cost, closely related to incremental cost, is stand-alone cost, or SAC. SAC is the economic cost of producing a service (or network element) in isolation from other outputs. Intuition, and available forward-looking engineering cost studies, indicate that for a logical aggregation of network elements, SAC does not differ significantly from long run incremental cost because there are no significant common or shared costs among the groups of network elements. That is because those aggregative categories of network elements generally comprise discrete physical facilities-e.g., loop, switching, transport, and signalling. Thus, there is no practical ambiguity, at this level of aggregation, in speaking about economic costs, SAC, and incremental costs interchangeably. At a finer level of disaggregation, there may well be non-trivial costs shared among various subcomponents of any particular aggregative network element. The competitive price for any such subcomponent must lie between the subcomponent's unit long run incremental cost and SAC. The revenues from the competitive prices of all the subcomponents of an aggregative network element must sum to the long run incremental cost of the aggregative network element.

comparing the expected costs of expansion or entry with the expected incremental revenue. Likewise, firms decide whether to contract or exit by comparing the costs avoided with the expected revenues foregone.

13. Consistent with the logic of competitive markets, the pricing of network elements on the basis of incremental cost should encourage new or potential entrants in local exchange markets to make efficient make-or-buy decisions, supplying a network element through self-provision only when the entrant can do so at a lower incremental cost than the ILEC. Basing the pricing of network elements on incremental cost is also a prerequisite for efficient purchasing decisions by the *ultimate* consumers of telecommunications services. Consumers are encouraged to make optimal use of expenditures permitted by their budgets only when prices reflect the relative scarcity of each good or service available in the market.

C. The Proper Time Horizon For Determining the Incremental Costs Of Network Elements Is The Long Run.

14. The competitive market model also dictates that the costs for pricing of network elements be based upon a long-run time horizon-- i.e., a time horizon long enough that sunk costs are variable, and obsolete or inefficiently configured assets are replaced with efficiently [*6*] configured assets under current technology.[2] In competitive markets, entry decisions are based on long run costs, for all costs of entry are variable before the necessary investment is sunk. Accordingly, the threat of potential entry in competitive markets limits prices charged by

[2] This conclusion presumes, of course, that demand for use of the network element is not declining so much that the network element is becoming obsolete.

incumbent firms to the long run costs faced by an efficient potential entrant.

D. The Pertinent Increment of Volume Is The Total Expected Demand For A Network Element Produced By An ILEC, Including Its Own Demand.

15. The relevant increment of output to be costed is the *total* demand of *all* uses and users of a network element (or group of network elements) sought by a requesting carrier, including the demand of the ILEC itself. Hence, the relevant measure of economic costs for unbundled network elements is the total service long run incremental cost, or TSLRIC.

16. Many network elements may be characterized by economies of scale. In competitive markets, capacity is sized to take appropriate advantage of those economies. Accordingly, basing the price of network elements on the incremental costs per unit of serving only a portion of total demand for a network element could inflate unit costs above efficient levels. It also would give an inefficient competitive advantage to ILECs, whose own needs for cost recovery are satisfied on the basis of the entire anticipated demand.

E. The Benefits Of Economic Pricing Can Occur Even Before The Emergence Of Facilities-Based Competition For Every Network Element.

17. The natural monopoly properties of some aspects of the local exchange market may create entry barriers that are strong enough to delay facilities-based competition for some network elements. The Commission's proposed rules will provide competitive benefits that are [*7*] significant and immediate, however, even before full facilities-based

competition develops in all segments of the local exchange markets.

18. In this regard, if competitive local exchange carriers ("CLECs") can secure the network elements they need from an ILEC at economic costs, then competition among the CLECs, and between the CLECs and the ILEC, predictably will drive end-user prices to competitive levels, and drive industry structures and costs to efficient levels. Indeed, requiring ILECs to offer network elements priced at TSLRIC-based rates (and also to offer complete local exchange services at wholesale prices to resellers) would serve the public interest even if facilities-based competition for every network element never materialized.

19. Further, requiring ILECs to sell unbundled network elements at prices based on TSLRIC will accelerate progress towards facilities-based competition by reducing economic barriers to facilities-based entry. Such unbundling and resale will enable entrants quickly to build relationships with end users based on marketing, customer service, and innovative modifications or additions to existing network elements, without incurring all of the risks inherent in making the enormous investments needed to build every element of an entire network simultaneously from scratch. The resulting commercial relationships with end users should in turn serve as a powerful springboard for integration backward through further facilities-based entry.[3]

---

[3] Concerns have been raised that network elements priced at TSLRIC would be so cheap as to deter efficient facilities-based entry. These concerns are unfounded. TSLRIC is a measure of *incremental* cost, not *marginal* cost. It includes *all* of the additional costs that society incurs by asking the incumbent carrier to supply the output of a network element. If another carrier cannot produce that output as cheaply itself, then its

(continued...)

[*8*]

F. TSLRIC Pricing Is Consistent With Properly Applied ECPR Principles.

20. The Commission has tentatively rejected proposals of certain ILECs to base the prices of interconnection or network elements on an application of the efficient component pricing rule ("ECPR") in a form supposedly advocated by us. Notice ¶¶ 147-148. The Commission's conclusion is proper, although for reasons that differ somewhat from those articulated in the Notice. In this regard, we continue to believe that principles of ECPR are valid and serve a usefule regulatory role. It is crucial, however, to understand the proper role of ECPR.

21. ECPR concerns the relationship between *appropriate* end-user prices and the correspondingly appropriate prices for inputs to end-user services, such as access to underlying facilities or, in today's language, for unbundled network elements. Under ECPR, a vertically integrated firm with market power over one or more components in the chain of production sets the price of an unbundled component at a level that does not exceed the sum of incremental costs and the contribution from the price of the end-user service that would be lost due to the sale of the component.

22. The existing structure of end-user prices for local telecommunications is *not* appropriate as a baseline for ECPR or any other pro-competitive purpose; it is utterly inconsistent with the competitive policies of the 1996 Act. Cross-subsidies are common in the rate structure, and rates depart systematically from pertinent costs. In these circumstances, the old structure

---

[3] (...continued)
facilities-based entry wastes resources and should not occur.

of rates is the wrong baseline for the pricing of network elements through the application of ECPR.

23. Indeed, applying ECPR to the existing rate structure would result in component prices that lock in the ILECs' monopoly profits and inefficiencies, would attract inefficient entry [*9*] where rates are too high, and would preclude efficient entry where rates are too low. ECPR was never intended to (and cannot) substitute for competition for the monopoly network elements, or limit to fully competitive levels the prices paid by end users for services that use those network elements.

24. Of course, as unbundling proceeds and competition spreads as a result of economic-cost-based pricing of network elements, end-user prices should be driven toward incremental costs. With the *appropriate* end-user prices at incremental costs, the component prices dictated by ECPR are no higher than TSLRIC.

II. THE COMMISSION SHOULD PRESCRIBE BASIC PRINCIPLES FOR ESTIMATING TOTAL SERVICE LONG RUN INCREMENTAL COST.

25. Valid TSLRIC models should recognize the following basic principles:

(1) TSLRIC measures the *forward-looking* costs of providing the network element is question.

(2) TSLRIC is based on the costs an *efficient, cost-minimizing* competitor would incur -- *i.e.*, the costs of assets that are optimally configured and sized with current technology and efficient operating practices. Proper TSLRIC estimates do not simply accept the architecture, sizing, technology, or operating decisions of the ILECs as bases for calculating TSLRIC.

(3) TSLRIC includes only the *additional* costs of providing the particular network element(s) being costed, holding constant the ILEC's output of other goods and services.

(4) TSLRIC is based on the entire demand of *all* uses and users of that element or group.

(5) TSLRIC estimates should reflect significant geographic cost differences.

[*10*] 26. We discuss each of these critical principles in turn. We also emphasize the need to take care in allowing any "add-ons" for recovery of costs common to or shared among more than one network element (and therefore properly excluded from a network element TSLRIC estimate) to assure that quantification and allocation of such "common" costs is consistent with the competitive market model.

A. TSLRIC measures the *forward-looking* costs of providing the network element(s) in question.

27. As noted above, the most important principle is that TSLRIC measures current, prospective, or forward-looking costs, not historic, embedded, or book costs. Economic costs are forward-looking and are based on the most efficient generally available technology. Forward-looking costs provide the basis for competitive prices, define the thresholds for cross-subsidization, and govern expansion, contraction, entry, and exit decisions in competitive markets. Book costs are unlikely to reflect economic costs accurately, and basing the prices of network elements on book costs would be dangerously counterproductive.

B. TSLRIC is based on the costs an *efficient, cost-minimizing* competitor would incur -- i.e., the costs of assets that are optimally configured and sized with current technology and efficient operating practices. Proper TSLRIC estimates do not simply accept the architecture, sizing, technology, or operating decisions of the ILECs as bases for calculating TSLRIC.

28. Proper measures of the TSLRIC also must exclude the costs of inefficient design or operations. This principle follows from the competitive standard because excess costs cannot be recovered in competitive or contestable markets. New entry in such markets can occur at any time, instantly, and in sufficient scale to capture all the incumbent's volume. The threat of such entry disciplines incumbents and prevents them from charging more than the incremental costs of providing a service in the most efficient, least cost manner. Furthermore, pricing at levels just sufficient to recover the costs of an efficient supplier discourages new entry by inefficient, [*11*] higher-cost suppliers. In contrast, allowing ILECs to include costs attributable to inefficient design or operations in charges for network elements purchased by rivals would weaken incentives for ILECs to operate efficiently, encourage inefficient bypass of ILEC network elements by new entrants, discourage efficient entry by downstream users of those network elements, and inflate the end user prices for local exchange and other services above competitive levels.

29. This issue is significant because the RBOCs' network architecture, design, technology, and operations reflect years of operation under the traditional rate-of-return regulatory model, which created both incentives and opportunities for ILECs to operate inefficiently and manipulate their reported costs to recover the costs of inefficient design and operations.

For example, many ILEC facilities whose costs are carried in the ILECs' regulated rate bases appear to have been designed and sized to provide advanced or nonregulated services, now or in the future, and seem to exceed the efficient size and capabilities of facilities designed for regulated services alone. ILECs should *not* be allowed to include such added costs in the TSLRIC of network elements.

B. TSLRIC includes only the *additional* costs of providing the particular network element(s) sought by the requesting carrier, holding constant the ILEC's output of all other goods and services.

30. The third basic principle is one of causality: TSLRIC includes only those added costs that are attributable to production of the network element or elements. Costs that are properly attributable to *other* outputs of the ILEC, the capacity to produce other outputs in the future, or costs that would be incurred even if the network element or elements were not supplied, are properly excluded from TSLRIC.

[*12*] 31. Thus, the TSLRIC of a network element purchased by another carrier *excludes* costs that are attributable to (1) the ILEC's retailing operations (e.g., marketing, billing), (2) other network elements, or (3) capacity acquired in anticipation of future expansion into other activities (e.g., fiber acquired in anticipation of providing broadband video services or interexchange telecommunications services). Capacity to provide new or future services is not necessary to provide basic network elements, and an efficient provider of network elements would not incur those costs.[4]

---

[4] We understand that the costs incurred in common between network elements and retail services are *de minimis*. Moreover, retail services are (continued...)

C. TSLRIC Is Based on the Entire Demand of *All* Uses and Users of a Network Element or Group.

32. As noted above, TSLRIC includes the additional costs of serving the total demand of all uses and users of a network element (or group of network elements) sought by a requesting carrier, including the demand of the ILEC itself. Production of many network elements is characterized by economies of scale. Defining TSLRIC by reference to the incremental costs of only a portion of total demand for a network element can inflate unit costs above efficient levels and would injure consumers by giving ILECs an inefficient competitive advantage over potential competitors.[5]

---

[4] (...continued)
provided at a separate, downstream stage of production, and the costs attributable to retail services should be recovered from retail customers. Inclusion of these separate costs in the measure of TSLRIC would give potential purchasers and end users misleading signals about the social opportunity costs of network elements offered by ILEC, and would result in cross-subsidy by the network elements.

[5] At the same time, there may be circumstances when a price *below* average TSLRIC is necessary to protect against competitive injury. For a new service provided by an ILEC with an existing network element, the marginal cost of the service to the ILEC may be less than the average incremental cost of the network element. Under those circumstances, TSLRIC pricing may be a barrier to efficient competitive entry. Protection against this outcome would be provided by an imputation rule which requires an ILEC to offer network elements to CLECs at prices not exceeding the imputed prices charged by the ILEC to itself for use of the network elements (with proper accounting for any retail subsidies).

[*13*] **D. TSLRIC Estimates Should Reflect Significant Geographic Cost Differences.**

33. TSLRIC estimates should reflect any significant geographic differences in cost. We understand, for example, that the costs of loop network elements may vary significantly by population density and topography. Ignoring these differences could give ILECs inefficient competitive advantages, particularly in high density urban areas where economies of density result in low per capita loop costs.

E. Recovery Of Carrier-to-Carrier Costs Are Not Casually Attributable To Any Single Network Element Should Be Consistent With The Competitive Market Model.

34. Some ILECs have argued that prices for network elements must be marked up *substantially* above TSLRIC to permit recovery of costs that are shared among multiple network elements. This claim is unwarranted.

35. We understand that the portion of forward-looking costs that is unattributable to particular network elements is likely to be small. The aggregative categories of network elements generally compromise discrete physical facilities – loop, switching, transport, and signalling. Economies of scope, or cost subadditivities, among these categories are likely to be minimal or nonexistent. To the extent that there are non-trivial common or shared costs among network elements, it is critical that the Commission establish strict limits on their recovery to avert arbitrary additives significantly above TSLRIC, which

could undermine the efficiencies and protection of competition offered by the TSLRIC benchmark.[6]

[*14*] 36. First, no recovery of unattributable costs should be allowed unless the ILEC shows that such costs must, in fact, be incurred (on a forward-looking, efficiency-maximizing basis) in common by or shared between the requested network element(s) and other network elements. Such a showing can be made by estimating the aggregate TSLRIC of all the outputs to which the unattributable costs are shared. In no circumstances should the Commission allow ILECs to satisfy this burden with data based on accounting allocations of embedded costs. Efficient costs are never measured by an ILEC's actual historical "overhead" expenditures.

37. Second, the difference between the TSLRIC of an aggregate of outputs, and the sum of the TSLRICs of each subset of those outputs, should be assigned to individual network elements on an efficient and competitively neutral basis. In particular, if the magnitude of the additional revenue to be recovered is too small to be of allocative or competitive significance, then a simple method of recovering the revenue through small markups applied to each network element could be justified by the litigation and other transaction costs avoided. Where the additional revenue is significantly large, the method

---

[6] Current ILEC accounting systems often classify certain expenses (e.g., the president's salary) as "common" or "overhead" even though a large portion of the expenses may be variable with respect to the volume of business, and attributable to particular network elements. Regardless of the arbitrary accounting label, costs of this kind are properly included in the TSLRIC of the relevant network element.

of revenue recovery should be consistent with allocative and competitive efficiency.[7]

38. Third, the sum of the incremental costs attributed to a requested network element (or elements), and the common or shared costs allocated to those elements, should never be allowed to exceed the stand-alone costs ("SAC") or TSLRIC of supplying those elements in the [*15*] aggregate. As explained above, SAC is the economic cost of supplying an output in isolation from other outputs. Prices in perfectly contestable markets can never exceed SAC.

III. THE HATFIELD MODEL APPLIES PROPER STANDARDS FOR ESTIMATING TSLRIC.

39. We have reviewed the costing model constructed for AT&T and MCI by Hatfield Associates, Inc., a telecommunications firm. The object of the current Hatfield model is to estimate the total costs of building and operating a network, using efficient, forward-looking technology, to supply all "basic" narrowband services (essentially all local and intraLATA toll service, including carrier access) currently supplied in the United States. We conclude that the Hatfield Model follows reasonably closely the TSLRIC principles discussed in Section II. Where limitations on the availability of data have forced the designers of the model to use approximations that deviate from the theoretical ideal, the shortcuts adopted tend to overestimate, not underestimate, true TSLRIC. Further, the model is extremely flexible: whenever more specific or accurate values are available, they can readily be substituted for the values used currently.

---

[7] In particular, an ILEC should not be allowed to charge other carriers a price for a network element that is higher than the imputed price charged by the ILEC to itself in the context of a competing offering.

A. The Hatfield model uses *forward-looking* costs, and estimates the costs of an *efficient, cost-minimizing* supplier.

40. The Hatfield model provides reasonable estimates of forward-looking, efficient costs. These first two of the TSLRIC tenets identified in Section II above - forward-looking and efficiency-maximizing – are, in our view, the critical elements of any legitimate TSLRIC study.

41. Our examination of the Hatfield Model investment calculations indicates that they entail a state-of-the-art data modeling approach in the construction of local loop, switching and transport, signalling, and operator services. In its assumptions, the model respects the requirement that the network (and associated functions) be configured in a manner that [*16*] minimizes the costs of providing narrowband, local exchange services, including access and interconnection. Hatfield's sizing of the network and selection of its architecture reflect all of the end-user and carrier-to-carrier demands that are put on the local network. We also understand that the model uses realistic fill factors.

42. The modular nature of the model permits TSLRIC estimates that satisfy the assumption that CLECs may provide some of the network functions using their own facilities. In other words, the assumed demands need not be the same for each network element but, instead, can be adjusted to reflect the effects of facilities-based entry.

43. The most sophisticated modeling of investment cost is that for costs associated with the local loop. This is appropriate, for we understand that investment in the local loop accounts for nearly half of the aggregate investment outlays captured by the model. The model also reflects the most efficient switching technology, and uses actual discounted prices rather than list prices for switching equipment.

44. Where the model falls short of the theoretical ideal, it tends to err in the direction of overestimation, not underestimation, of actual TSLRIC. First, since adequate data are not yet available to model a local exchange that is fully optimized in the locations of wire centers and tandem switches, the model assumes that the existing locations are optimal. If and when the modeling of optimal locations becomes feasible, those locations can readily be substituted as inputs for existing switch locations. Such an adjustment should reduce, not increase, the TSLRIC estimates produced by the current version of the model.

45. Further, the population is assumed to be uniformly distributed in the model. In actuality, ILECS are free to deploy their networks to take advantage of population variations, [*17*] siting wire centers in or near population concentrations where possible. Here again, we understand that the model errs on the side of conservatism.

46. The model estimates forward-looking non-investment expenses by scaling down certain operating expense data from existing ILECs by the same ratio of efficient, forward-looking investment costs to historic ILEC investment costs. This approach is intuitively plausible insofar as competition in equipment supply markets encourages advances that lower both initial investment and operating expenses.

B. The Hatfield mosel estimates only the *additional* costs of providing the particular network elements except where data limitations result in the inclusion of costs shared between two or more network elements.

47. Our review of the model confirms that its estimates are limited, where possible, to the economic costs of particular network elements. First, the model uses an engineering rather

than an accounting approach to cost estimation. Consequently, it does not need the arbitrary cost allocations that are inevitably associated with cost studies based on accounting of cost data.

48. Second, network elements whose costs are estimated by the model are defined at a level of sufficient aggregation to include most costs that would otherwise be shared between individual network services. As a result, the share of total costs not captured in the pertinent TSLRICs is likely to be small. This minimizes the need for potentially arbitrary judgments about the proper treatment of various cost components.

49. Finally, where the model deviates from efficient incremental costing, the deviations are likely to overestimate, not underestimate, the resulting cost values. For example, the costs of local or tandem switching are estimated on a stand - alone basis, without regard for the economies of scope associated with production of switching along with signalling.

[*18*]

C. The Hatfield model takes into account the entire demand of *all* uses and users of a network element or group of network elements.

50. The Hatfield model also deals with the entire demand for each network element, and the Hatfield unit cost estimates assume that switches, trunks, and other assets are sized to produce at least the level of current output. The resulting TSLRIC values should therefore reflect most of the potential economies of scale permitted by current demand levels.

D. The Hatfield model recognizes significant geographic cost differences.

51. Finally, the Hatfield model is slightly sensitive to variations in geography and population density. These differences can have potentially significant effects on estimated costs. Ignoring these divergences from average values can create incentives for inefficient entry, opportunities for anticompetitive cross-subsidies, and obstacles to full cost recovery for the ILECs. Our review of the Hatfield model indicates that the estimated TSLRICs are as free as possible from these distortions.

IV. ECONOMICALLY DEFENSIBLE PRINCIPLES OF RATE DESIGN ARE IMPORTANT.

52. We understand that the Commission has not limited its inquiry to appropriate principles for determining overall rate levels, but also proposes to adopt certain rate structuring principles. This is entirely proper and commendable, for even if rates are set at the right overall levels to recover true economic costs (as measured by appropriate TSLRIC modeling), inappropriate rate structures can impair competition, create inefficiencies, and harm consumers.

53. Most fundamentally, efficiency-maximizing network element rates should, to the extent reasonably possible, recover costs in a manner that reflects the way those costs are caused to be incurred. We understand, for example, that most or all of the costs are attributable to a number of the ILEC network elements proposed to be unbundled are driven by capacity, not [*19*] usage. The costs of such network elements, which when purchased by a CLEC are essentially dedicated to that CLEC's use and not shared by others, can be attributed directly to that CLEC. Capacity charges are

efficiency-maximizing in those circumstances.

54. Usage-sensitive charges, by contrast, could lead to inefficient outcomes at both ends of the usage spectrum when costs vary with capacity, not usage. First, because usage sensitive network element charges would exceed the true economic cost of serving high volume end users, such charges would encourage inefficient CLEC bypass of the ILEC network to serve those customers. At the same time, usage sensitive charges that did not reflect the true economic cost of serving low volume end users would encourage inefficient levels of CLEC purchases of the network elements in question.

55. Usage charges may be appropriate, however, when capacity costs cannot be readily attributed to particular CLECs or end users. An example is common transport. The conceptually correct cost driver is capacity, with its cost recovery apportioned among individual users or uses in manners sensitive to their share of the total demand during peak periods. We understand that accurately determining the relative responsibility for total demand during these periods may be currently infeasible, however. Here, usage charges may make economic sense.

V. PRIVATE NEGOTIATIONS ARE UNLIKELY TO ACHIEVE ECONOMICALLY DEFENSIBLE RATE LEVELS UNLESS THE COMMISSION PRESCRIBES THE BASIC PRINCIPLES FOR ECONOMIC COSTS.

56. The Commission has properly proposed to prescribe standards for determining TSLRIC, rather than leaving the pricing of network elements to unconstrained bargaining between ILECs and other carriers. Without a firm regulatory constraint, the ILECs' market power is likely to yield bargaining outcomes that are one-sided, anticompetitive, and

inefficient.

[*20*] 57. A regulatory model with predictable litigation outcomes will increase the likelihood of settlement. If an ILEC and an entrant seeking to purchase network elements both know that the alternative to voluntary agreement is arbitration or adjudication based on TSLRIC pricing principles, both parties will be motivated to negotiate in good faith to reach an individualized agreement. Arbitration or adjudication by a third-party, no matter how wise and well-informed, is inevitably based on incomplete information and thus is almost certain to be less accurately shaped by commercial reality than is fully optimal. Determination of prices through private agreement can make both sides better off, for it can adapt itself effectively to the commercial details on the basis of more complete information. The potential gains from private negotiations can be realized, however, only if the regulatory backstop excludes the possibility of one-sided monopolistic outcomes.

58. Analogous experience in the railroad industry underscores these propositions. Major amendments to the Interstate Commerce Act of 1976 and 1980 left the standards for railroad rate regulation in flux for a number of years. By 1981, the Interstate Commerce Commission faced a backlog of several hundred unresolved rate disputes between railroads and shippers. In late 1983, the ICC proposed to limit rates with constraints based on forward-looking economic costs. The proposed standards were adopted in final form in 1985, were applied in a number of individual rate adjudications in the mid- and late 1980s, and were endorsed by the railroad Accounting Principles Board in 1987. The new rate standards, while not costless to litigate, yielded generally predictable results. We understand that since the late 1980s, the overwhelming majority of rates have been established through voluntary contractual agreements rather than litigation.

[*21*]

VI. SUBSIDIES FOR UNIVERSAL SERVICE SHOULD BE KEPT TO A MINIMUM, AND IMPOSED IN A COMPETITIVELY NEUTRAL MANNER.

59. Whatever their intended purpose, deliberate deviations between network element prices and economic costs should be kept to a minimum. Deviations of this kind inevitably distort the allocation of resources, create incentives for inefficient facilities-based entry into areas with excessive carrier prices, and create artificial barriers to efficient facilities-based entry in areas where rates are too low.

60. A deliberate wedge between prices and TSLRIC is most likely to result from a decision to subsidize universal service or other regulatory goals. It is vital for the public interest that such deviations from competitive pricing be as small as possible, and that both funding and distribution be carried out through mechanisms that are *competitively neutral* -- i.e., that do not distort competition between the ILEC and its potential rivals.

61. To be competitively neutral, a regulatory wedge between prices and TSLRIC must never favor new entrants over incumbents, or *vice versa*. It must not benefit the proprieter of a bottleneck service over a rival that purchases the service. It must not favor firms that use one type of technology over another. The reason is obvious: an such departures from competitive neutrality tend to channel the business to inefficient suppliers. This inefficient allocation of business will raise costs, repress innovation and investments and -- as usual when competition is subverted -- needlessly burden consumers.

62. For example, competitive neutrality would plainly be violated if regulation permitted (or required) the ILEC to price some end-user service, call it "service L," below its

TSLRIC, and to make up the financial difference through markups above TSLRIC on prices for carrier-to-carrier services. The below-cost pricing of service L by the ILEC, funded by overcharges for [*22*] services supplied to competing carriers, would prevent CLECs from competing successfully for the end-user service *even if more efficient than the ILEC.*

63. The same regulatory goal can be achieved in a competitively neutral fashion by (1) providing an equal subsidy to *any* firm that supplies a unit of service L; and (2) collecting funds for the subsidy from carriers or end users, *irrespective of* the identity of the supplier providing the service or serving the end user. With such a competitively neutral mechanism, the end users of service L would still face the (intended) below-cost price, and the end users of other services would still be the source of funding for the subsidy. Significantly, however, the competitively neutral subsidy would enable the most efficient carrier to succeed in serving the end-users of service L and the other services that help support service L. And since each rival, including the ILEC, would receive the same unit subsidy by providing service L, each could price down to its own unit cost, less the subsidy. Just as in a subsidy-free environment, the low-cost supplier could win the business.

DECLARATION OF ROBERT W. CRANDALL

* * *

[*2*] Commission's Notice of Proposed Rulemaking in this proceeding. In these comments, I focus only on the economic issues involved in pricing resale, interconnection and unbundled rate elements under Section 251 of the Act.

Summary

3. The new Telecommunications Act establishes a number of new unbundling, interconnection and pricing requirements on incumbent local telecommunications carriers that the Federal Communications Commission and state regulators will have to implement with great care because of existing local rate structures. These rate structures have not traditionally been based on the cost of service, but have instead reflected the judgments of regulators that business subscribers should subsidize residential subscribers, that urban subscribers should subsidize rural subscribers, and that heavy users of interexchange services should subsidize local subscriber dialtone line rates. The rates established for unbundled elements, interconnection, and resale of local service – if set equal to economic costs, as some parties here have argued – will inevitably set in motion substantial arbitrage that will undermine the existing rate structure and could even imperil some local exchange carriers. Failure to consider how these provisions interact with one another and with the existing rate structure in the more competitive era mandated by the Act could have very serious, indeed, even dramatic consequences.

Sources of Competition

4. The 1996 Act requires states to allow competitive entry into intrastate telecommunications markets. It foresees the entry of facilities-based carriers and requires that

* * *

[*6*] LECs are inefficiently required to offer services at wholesale prices that are below incremental cost, the incumbents should receive the universal-service subsidies for these subscriber lines.

Pricing Unbundled Elements, Call Termination, and Interconnection

10. The new Act requires incumbent LECs to provide access to unbundled network elements at technically-feasible points. The charges for the use of such elements must be "just and reasonable." From an economic standpoint, the pricing of any network function, whether for termination, interconnection, or any other purpose, should be based on long-run incremental costs, but such pricing should be regulated in the context of a carrier recovering its total costs. Because the pricing of services or elements at long-run incremental cost will likely leave the carrier far short of covering its fixed and/or common costs, even on a forward-looking basis, LRIC must be marked up to allow for full cost recovery including a return on the requisite capital if the sum of the LRIC- based rates do not cover all forward-looking costs. Under this condition, the pricing of any element, of call termination, or of interconnection should not be considered in isolation. The degree of mark-up over LRIC of each should be determined on the basis of its effect on overall economic welfare.

11. As I explain below, the measure of LRIC on which rates should be based is the cost of building and operating actual LEC networks, not hypothetical new networks that do not exist today and may never exist. If LECs are to continue as regulated entities, their rates must be based on the costs of operating the networks that they have been permitted to build under regulation. [*7*]

12. It is particularly important that call termination charges or interconnection charges not be set at zero – so-called "bill-and-keep" – on the basis of some hypothetical notion that a carrier's in-coming and out-going services are in rough "balance." A zero charge for any service whose LRIC is positive is clearly inefficient and will create the wrong incentives for building and operating facilities. Moreover, a zero charge for interconnection serves to subsidize those entrants that operate with a large surplus of out-going traffic.

13. If the current system of interexchange origination and termination rates – "access" charges – is continued while interconnection rates and the rates on unbundled elements are set at or near actual cost, very strong incentives will be created for other carriers or large customers to divert interexchange calls through competitive networks, disguising interexchange traffic as interconnected local traffic. To prevent such arbitrage and potentially uneconomic bypass, the Commission and state regulators must move rapidly to rebalance rates and to reform the existing access charge regime. But until this rebalancing occurs, the Commission and state regulators must enforce prohibitions against bypassing the current interstate and intrastate access charges levied on toll calls.

Embedded Versus Forward-Looking Costs

14. The 1996 Telecommunications Act does not establish whether the rates for unbundled services and interconnection should be based on actual embedded costs, LRIC, or TSLRIC (total-service long-run incremental cost). There could be very large differences among these [*8*] measures for various network functions, and these differences could be magnified by the fact that forward-looking costs – such as LRIC or TSLRIC – necessarily involve engineering judgments about the cost of constructing optimal networks or expanding current networks under current prices and technology.

15. It is important that the Commission and state authorities recognize that the rates for unbundled elements and interconnection are still regulated rates unless the interconnection rates are the result of negotiation between the incumbent and entrants. The regulators will therefore be faced with a choice: relying on the actual embedded accounting costs of the incumbents or arbitrary, hypothetical engineering-economic analyses of forward-looking costs, such as LRIC or TSLRIC. There are simply no market analogues for LRIC or TSLRIC. Indeed, the advocates of using such measures are often precisely those firms who wish to enter local telecommunications markets by relying upon incumbents' networks, not by building the networks that would generate measures of LRIC and TSLRIC.

16. There is moreover no way to know what these hypothetical, competitive networks look like. Are they wireless networks? Or are they fiber-coaxial cable networks, capable of offering switched video, data, and voice services? If we are to

believe one study already placed in this record,[6] these new networks from which TSLRIC estimates are to be derived are simply hypothetical efficient, modern replications of existing local-telephone company networks. [*9*] Unfortunately, there is simply no evidence that such hypothetical networks would represent an efficient use of society's resources. If this were not the case, someone would be building them. In short, the use of forward-looking estimates of costs, such as TSLRIC, requires regulators to know better than the market what are truly efficient network designs. This is surely a debatable and even dangerous assumption.

17. If the Commission chooses to adopt the forward-looking approach of TSLRIC in guiding the rate-making process for unbundled elements and interconnection, it should at least require that the hypothetical estimates of TSLRIC include all of the joint and common costs that would be required for even a new, modern carrier. For instance, the Hatfield study that has been submitted in this proceeding attributes less than 10 percent of current LEC customer-service and corporate operations costs to the TSLRIC of network operations. The remainder reflects more than half of the gap between embedded costs and its estimate of TSLRIC.[7] Given that this calculation is based on the operation of a hypothetically "efficient" new network, there is no real-world operational basis for this assumption. To establish rates for unbundled elements and interconnection on the basis of these hypothetical and necessarily arbitrary calculations of overhead and customer-service costs is obviously a precarious enterprise.

---

[6] I refer to the Hatfield study cited in fn. 5, above.

[7] Hatfield, op.cit., p. 36.

18. The 1996 Act establishes a new framework for local competition in telecommunications. Local telephone companies may no longer operate as franchised [*10*] monopolists subject to oversight by state commissions. As new entry occurs and the incumbents are forced to unbundle their networks and offer interconnection with other carriers, the risk to their shareholders rises markedly. Therefore, in calculating any forward-looking measure of costs, the estimate of the costs of capital must necessarily rise as well. It would be incorrect to assume that one can calculate LRIC or TSLRIC in this new competitive era by reaching back to old state regulatory proceedings or to any period in the pre-1996 era for estimates of the cost of capital to regulated local carriers. The additional risk to shareholders must be factored into these estimates of the cost of capital.[8] However, the Hatfield study offered by MCI in this proceeding uses a cost of capital of less than 10 percent, based on an estimated cost of equity capital of only 12 percent. Given the riskiness to investors in LEC equities in the post-1996 Act environment, this assumed cost of capital would appear to be perilously low.[9]

---

[8] This risk is likely to be reflected in higher borrowing rates (for bonds) and higher returns on the needed equity to reward stockholders for assuming this new risk from competition.

[9] Indeed, the estimated Beta coefficient – a widely used measure of relative risk – for most LECs has been rising for some time, reflecting the market's judgment that the riskiness of local-exchange operations is rising in the increasingly - competitive telecommunications sector.

AFFIDAVIT OF PROFESSOR JERRY A. HAUSMAN

1. My name is Jerry A. Hausman. I am MacDonald Professor of Economics at the Massachusetts Institute of Technology. I received an A.B. degree from Brown University and a D. Phil. (Ph. D.) in Economics from Oxford University. My academic and research specialties are econometrics and microeconomics. I have done extensive research on economics of the telecommunication industry and have frequently testified before the FCC on issues related to regulation of local exchange companies. In 1985 I received the John Bates Clark Award of the American Economic Association for the most "significant contributions to economics" by an economist under forty years of age. I have been retained in the above-captioned matter by the United States Telephone Association.

I. Summary and Conclusions

2. The same economic principles should be used in the pricing of interconnection, unbundled network elements, and transport and termination services. Economic efficiency requires that goods and services be produced in the least cost manner. Cost based prices for interconnection, unbundled network elements, and transport and termination will lead both the seller and the buyer of those services to make economically efficient choices. The first principle of an economic approach to interconnection charges is thus that a LEC should be compensated for its costs of providing such interconnection. Undercompensation will provide disincentives for LECs to invest in their networks over time and may make it cheaper for a [*2*] competitor inefficiently to use an existing network rather than build its own competing facilities.

3. Numerous regulatory distortions and other economic factors weigh strongly against applying long-run incremental pricing to interconnection and network elements. For a single-product firm in a competitive market free of regulatory distortions, economic theory recommends prices based on long-run incremental cost. LECs, however, are multi-product firms with economies of scale and scope that result in joint and common costs arising from network investment. These costs need to be recovered for a LEC to continue to make efficient investments in its network and to stay in business. TSLRIC (or LRIC) does not permit these costs to be recovered in an economically efficient manner. LECs also have historical costs due to past network investments. Technological change will deprive LECs of recovering costs if rates are always measured on the basis of a forward-looking optimal network model. Yet a policy setting rates on that basis would create incentives for LECs to underinvest. Productive efficiency requires that embedded costs of efficient investment in the network be recovered by the LECs.

4. Until federal and state regulatory distortions, and subsidization of services created to serve regulatory policy objectives, are eliminated, it would be inappropriate regulatory policy and incorrect economics to price interconnection at TSLRIC or LRIC because of the significant regulatory arbitrage which would be created and because a significant source of contribution to fixed and common costs would not be replaced by an alternative source. Even then, no firm will be totally free of joint and common costs; therefore it would not be appropriate for the Commission to mandate pricing at TSLRIC or LRIC. Also, the "reasonable profit" allowed by the 1996 Telecommunications Act (1996 Act) will not be possible if interconnection prices are set at LRIC or TSLRIC.

[*3*] 5. The same principles dictate that reciprocal compensation arrangements for transport and termination must cover the costs of providing those services. Policies that may lead to underrecovery, such as bill and keep, lead to market failure and economic inefficiency.

6. The "avoided-cost" standard for establishing wholesale prices under the Act is economically efficient. Avoided costs should be measured as the additional costs of providing a service at retail assuming the service is already being provided at wholesale. That is to say, the wholesale price should be set at the retail price, less avoided costs, plus costs incurred in wholesaling the service. The efficient discount for wholesale prices is thus net avoided cost.

II. The Pricing of Interconnection, Network Elements, and Transport and Termination

7. For an unregulated, single-product firm, economic theory holds that efficient prices should be based on long-run incremental cost. Interconnection, network elements, and transport and termination are intermediate goods. If the price for an intermediate good (or input of production) exceeds its cost, the user of the intermediate good will tend to shift to a lower-priced, but potentially higher-cost, input. Because economic efficiency requires that the lowest cost input be used, society's resources will be wasted. This loss of productive efficiency is an aspect of the overall loss in economic efficiency that occurs if rates are not set at incremental cost.

8. However, numerous regulatory distortions and other economic factors recommend against applying this incremental-cost rule to interconnection pricing. Most importantly, LECs are multi-product firms with economies of

scale and scope that result in joint, common and embedded costs arising from shared [*4*]facilities and network investment.

* * *

[*6*]have invested billions of dollars in their existing networks. If prices do not take account of those economic costs, an incentive will be created for the new CLEC entrant to minimize its cost while taking advantage of the existing networks and not paying for usage. Such market failure will cause future underinvestment in networks because companies will understand that they will not be able to recover their economic costs.

13. Thus, LRIC or TSLRIC may provide a starting point for calculating regulatorily mandated interconnection prices but, because LECs must cover their joint, common and historical costs as well, incremental costs cannot be a ceiling for those rates. No economic basis exists for the Commission to issue a rule restricting interconnection prices to LRIC (or TSLRIC).[3]

B. The Reasonable Profit Standard of the 1996 Act

14. A further consideration is that interconnection rates set at LRIC, or at TSLRIC, do not include the "reasonable profit" which the 1996 Act permits. Two economic reasons lead to this conclusion. First, telecommunications equipment prices have been decreasing so that LRIC or TSLRIC, which is forward looking, will lead to a lower cost estimate than the

[3] In competitive situations LECs may voluntarily lower rates to LRIC to meet competition. LRIC is a valid floor for competitive rates because it allows marginal-cost recovery but not predation.

actual costs incurred by a [*7*] LEC in building its network.[4] If LRIC or TSLRIC is used, a reasonable profit will not be earned by the LEC. Instead, an economic loss will be incurred by the LEC because it will not recover the cost of its investment. The NPRM recognizes this problem when it states that "setting the price of discrete services and elements equal to the forward-looking LRIC of each service or element is not likely to recover the historical costs of incumbent LECs' networks." (¶ 144) If the Commission, through its regulatory policy, causes LECs to lose money on economically efficient investment, it will discourage future investment and contravene the explicit language of the 1996 Act which states it is designed "to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans."[5]

[4] Even if actual historical network investment decisions were always completely efficient at the time they were made, improvements in technology will always guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place (or otherwise the older technology could be used in the hypothetical network). Thus, basing cost on the current most efficient technology will impart a downward bias on estimates of actual network costs, causing an economic loss to the LECs which made the historical investment. Thus, the study method proposed by Hatfield and Assoc. (March 1996, submitted on behalf of MCI) which claims that the existing network is "irrelevant" (p. 16) is incorrect as a matter of economics and would lead to a downward biased estimate of LEC costs. In a competitive market situation, a potential entrant could choose a new technology, but if the potential entrant decides not to enter, the hypothetical costs do not enter the pricing decisions. Thus, MCI can decide to invest in a network, but otherwise, the actual costs should be used to set prices, not hypothetical costs.

[5] Economic theory has focussed recently on the problem of "time consistency" in government policy. If the government (or regulators) confiscate private investment through taxation (or low mandated rates), the

(continued...)

15. The second reason that the "reasonable profit" requirement would not be satisfied is that some of the costs of the network will be fixed and sunk, even within the forward looking horizon of a LRIC study. These sunk costs will not be counted in the forward looking costs of a LRIC study, but they [*8*] are again investments incurred by the LEC in building its network. Failure to account for these sunk costs will again lead to the outcome that the LEC will not earn a "reasonable profit", but instead will face an economic loss and face inefficient investment incentives.

16. The NPRM's proposal that a transitional pricing mechanism could be set at short-run marginal costs (¶ 132) directly contravenes sound economic principles. Short-run marginal costs do not account for the cost of capital at all. Thus, short-run marginal costs would not cover the joint, common, and historical costs of providing the service, let alone yield a "reasonable profit". The use of a marginal cost standard would be equivalent to a forced monetary transfer from the LECs to their competitors. Such a transfer would reduce economic efficiency and is inconsistent with the obligation of regulators to allow a regulated company the opportunity to cover its costs, including a return on capital invested.[6]

---

[5] (...continued)
market will build this risk into higher discount rates which will lead to decreased future investment. Causing an economic loss on efficient investment through regulatory policy is a form of confiscation by the FCC.

[6] To an economist, profits are measured as revenues minus costs. Costs include wages, material, and the cost of capital. To achieve the "reasonable profit" allowed by the 1996 Act, a markup above LRIC is required to help cover the fixed and common costs of the network which are not included in LRIC or TSLRIC. Indeed, regulation of LECs has often considered profit, (continued...)

C. <u>The Use of Proxy Variables to Set Rates</u>

17. Measurement of costs, no matter how defined, is in my experience labor intensive, time consuming, and contentious. The NPRM raises the possibility of using proxy variables to set rates (¶ 134). The idea provides significant potential benefits because transaction costs are likely to be much lower if the Commission provides a safe harbor that both parties know is[*9*] acceptable.

---

[6] (...continued)
also often called contribution, as the difference between revenue and embedded cost. Thus, the "reasonable profit" criterion of the 1996 Act is consistent with past regulation of LECs, because without profit to pay for the joint and common costs, LECs would go out of business because the total revenues would be below their total costs on a company-wide basis.

COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

* * *

[*28*]

D. Pricing Issues

1. Rates for Interconnection and Network Elements Can Be Determined by Means Other Than Traditional Cost of Service Regulation.

The FCC tentatively concludes that language in the Act precludes states from setting rates by using traditional cost of service regulation, with its detailed examination of historical carrier costs and rate bases. NPRM, ¶123. The FCC goes on to state that the statute appears to contemplate the use of other forms of cost-based price regulation, such as price cap regulation or setting the prices based on forward-looking cost methodology, such as long-run incremental cost ("LRIC"), that does not involve the use of an embedded rate base.

The CPUC has been using price cap regulation for its two largest LECs, Pacific Bell and GTEC, for the past seven years. Last year, the CPUC began regulating one of California's mid-sized LECs, Citizens Telecommunications Company, under price cap [*29*] regulation. These three companies serve more than 97% of the access lines in California. The CPUC has also identified TSLRIC as the standard for the cost studies being prepared in the unbundling proceeding. It is important to note that both Pacific and GTEC have submitted TSLRIC studies that use current expenses. These studies assume the use of least cost technologies that are

currently deployed, and at current investment cost, together with the most current actual operating expenses.

2. The CPUC Is In the Process of Setting Prices for Unbundled Elements.

The FCC states, "[t]he California Public Utilities Commission has set prices for unbundled elements based on a forward-looking calculation of TSLRIC, which excludes shared and common costs." NPRM, ¶127. The CPUC has not yet set its prices for the unbundled elements. That issue will be the subject of hearings this summer with a final order due in December 1996. The CPUC has adopted TSLRIC as the standard for developing the costs of the unbundled elements. (See Attachment 3 on Consensus Costing Principles.) In the hearings this summer, the CPUC will determine the unbundled network elements and what level of shared and common costs should be included in the price of each unbundled element.

Attachment C

STATE OF CONNECTICUT

DEPARTMENT OF PUBLIC UTILITY CONTROL
ONE CENTRAL PARK PLAZA
NEW BRITAIN, CT 06051

DOCKET NO. 94-10-02 DPUC INVESTIGATION INTO THE UNBUNDLING OF THE SOUTHERN NEW ENGLAND TELEPHONE COMPANY'S LOCAL TELECOMMUNICATIONS NETWORK

June 15, 1995

By the following Commissioners:

Thomas M. Benedict
Reginald J. Smith
Michael J. Kenney

DECISION

[*9*] necessary to generally set forth the two principal cost methodologies discussed in this proceeding.[39]

Long-Run Incremental Cos (LRIC) - an economic technique that considers an increment of demand smaller than the demand for the total service. This methodology is designed to determine the additional cost per unit that the supplier will actually incur (or the economic benefit that will be realized) over time with any increase (or decrease) in providing the volumes of the service that are under consideration. Kahn Testimony, p. 3.

Total Service Long-Run Incremental Cost (TSLRIC) - an economic technique that is a modification of the LRIC approach but employs the total demand for a service as a base for calculation. In the current proceeding, two versions of TSLRIC were debated, one introduced primarily by SNET (hereafter referred to as TSLRIC(SNET)) and the other by MCI (hereafter referred to as TSLRIC(MCI)). Some explanation of each is necessary in order to properly frame the discussion later in this decision and the Department's specific conclusions.

TSLRIC(SNET) presumes that a substantial level of physical plant investment has already been made by the LEC and concerns itself only with determining the incremental costs of providing additional service in the future using available,

---

[39] A third type of cost study was presented, but not as a substitute for incremental cost analysis. The AG and OCC advocate consideration of stand-alone costs as an additional cost standard. Tr. 02/01/95, pp. 260-62; Gabel Testimony p. 7; Tr. 03/01095 pp. 703-07; Cooper Surrebuttal Testimony, p. 11-12. Stand-alone costs are not incremental costs, but the cost of producing a single service separately from all other services. Tr. 03/01/95 p. 623.

least cost technologies. Tr. 01/31/95, p. 16. TSLRIC(SNET) constructs its evaluation upon a company's existing technological investment and logistics and considers the total avoidable costs if the service were to be discontinued. Tr. 03/01/95, p. 649. Both of these principles are generally accepted techniques and previously approved by this Department. SNET considers the existing network and cost structure as a given to determine the most efficient changes to its facilities. According to SNET, investment decisions would be substantially different if existing investment was not incorporated in the model. Tr. 2/1/95, p. 209.

TSLRIC(MCI) proposes, on the other hand, that the Department authorize use of a modified TSLRIC methodology that accepts as a given the locations of existing basic facilities, but assumes for the exercise that the physical facilities themselves do not currently exist. In doing so, MCI implicitly concludes that the physical plant in use by SNET today could constitute a relatively inefficient economic decision and, therefore, a substitute architecture is necessary from which all incremental cost can be better determined. This somewhat existentialist methodology has attracted a certain level of regulatory interest throughout the country, but has yet to achieve a level of general acceptance by either regulators or the industry.

[*10*] In testimony before the Department, MCI suggested that a "scorched node" approach such as it has proposed with TSLRIC(MCI) was essential to characterizing a more accurate representation of incremental cost in such a dynamic and changing technology climate. MCI proposed the Department employ a model that employs a conceptual geographic template in which locations of all existing routes and facilities are accepted as given and, on a forward looking basis, only the

most modern, least cost technology is utilized to satisfy incremental requirements for service. Though MCI accepts the fact that this does not produce the real incremental cost of service, in MCI's view, it produces the most desirable outcome (i.e. the lowest possible incremental cost). Tr. 3/1/95, pp. 734-35.

Having set forth this general overview of the main debate surrounding the issues of TSLRIC methodology, the following section provides in more detail the respective participants positions on the matter.

C. Positions of Participants

1. The Southern New England Telephone Company

SNET appears in this proceeding as the principle subject of the Department's investigation of cost-of-service methodologies. Other participants in this proceeding, though their participation is essential to defining the most appropriate technical outcome, are generally not telephone companies and are, therefore, not subject to the conditions placed upon SNET by this proceeding and Public Act 94-83. Because of it's unique position, SNET availed itself of the opportunity to offer comment upon both the suitability of current cost-of-service methodologies previously prescribed by the Department as well as techniques proposed by other participants in this proceeding.

SNET constructs its position in this proceeding on independent, but related, arguments. First, SNET contends that its proposed methods of calculating cost of service are consistent with those prescribed by the Department's past decisions in Docket Nos. 88-03-31 and 89-12-05. SNET

Comments, p. 12. Second, SNET suggests that the incremental cost methods adopted by the Department in those proceedings were purposefully chosen because of their presumed utility in a competitive marketplace such as that envisioned by Public Act 94-83. SNET Comments, p. 13. Third, SNET suggests that its proposed cost-of-service methodologies adhere to sound economic principles, will foster competition and will do so in the most efficient and effective manner possible. SNET Comments, pp. 16 and 21. Fourth, SNET states that the study periods it currently uses are generally three to five years in duration, sufficiently suitable for this Department's planning efforts. Finally, SNET suggests that its methodology is sufficiently flexible to meet future uncertainty because investment costs are generally not limited to the study period given the use of techniques that extend the study period over the service life of the investment.

On the other hand, SNET expresses unqualified disagreement with MCI's proposed methodology for determining incremental cost-of-service in the future.

AFFIDAVIT OF EDWARD C. BEAUVAIS, Ph.D.

* * *

[*2*]

The pricing of telecommunications services has three fundamental purposes: 1) revenue generation; 2) distribution of costs across customers; and 3) allocative efficiency. The first two items are largely a matter of rate level, the third is a rate structure issue.

Telecommunications pricing has three fundamental purposes: (1) To generate revenues at least sufficient to cover the costs of the firm; (2) To distribute the recovery of those costs among customers; and (3) To create economic incentives to align production and consumption decisions. Clearly the issue of cost arises in all of these areas, so that costing and pricing are related. However, they are not the same and it is very important in developing an efficient and economically correct cost methodology that the two concepts not be confused.

The first fundamental purpose of pricing is to cover the firm's cost. Prices must produce sufficient revenues to cover the firm's costs. Once the total costs have been determined, it must be decided which customers will recover what proportion of the costs. This is clearly where much of the dispute in telecommunications pricing occurs. In an adversarial proceeding it is always in the interest of one group to view the firm's costs as revenues to be collected from someone else. The proposal set forth herein will assign costs in an economically efficient manner.

The LECs should be allowed the opportunity to recover their costs. FDC does not produce the correct result.

An FDC study requires all costs to be allocated to all products and services, even when there is no direct **causal** linkage among the costs and the products. *The greater the number of products offered over joint and common facilities, the more difficult and misleading this distribution of costs becomes.*

Economic theory is absolutely clear that the relevant costs to look at in making pricing decisions are incremental costs. For expository purposes, I am using incremental and marginal cost interchangeably. So long as the marginal revenue derived from the sale of one more unit is greater than the incremental cost of producing and selling that unit, a profit maximizing firm would want to sell that unit. Likewise from a public policy perspective, so long as the marginal benefit (price) to consumers is greater [*3*] than the incremental cost, society is made better off by producing and consuming the additional unit. FDC totally disrupts this decision process. The incremental benefits to the firm/public should be compared to marginal/incremental cost - not fully allocated/fully distributed costs. Thus, I strongly urge the Commission to avoid *any* linkage between FDC cost study results and pricing.

Incremental costing is the initial starting point for pricing decisions. Pricing all services at incremental cost is not feasible given the level of common costs in an efficient firm.

Given my understanding of FCC objectives and the rivalrous nature of the marketplace, incremental costing should be employed as the starting point for pricing decisions. Incremental costing is useful to establish a floor to avoid cross

subsidization.[1] However, joint and common costs must also be recovered. It is widely acknowledged that pricing all services at marginal cost will yield insufficient revenues in the presence of economies of scope and scale. Given this result, the intersection of the first two fundamental purposes of telecommunications pricing implies that prices must depart from a first-best world measured in terms of marginal benefits equaling marginal costs. Simultaneously, the public policy objectives of the Commission will also require some departures from strict adherence to economic first-best rules. However, when such departures are required, the movement away from marginal cost pricing should be made in the most efficient manner possible. *Movements away from strict adherence to marginal cost pricing must take into account the demand characteristics of customers if an efficient outcome is to be achieved and the firm is to recover its total costs.*

It is the movement away from strict accordance with marginal cost pricing where the firm's common costs are recovered. That is, one need not assign or allocate the common costs to all services prior to engaging in the pricing exercise. It is sufficient to know their value in aggregate along with the [*4*] incremental costs of the array of products and services. The pricing of the services can then be done by taking into account the demand characteristics of the services, so that the

---

[1] It must be acknowledged that the Commission has public policy objectives other than economic efficiency in pricing. However, the pursuit of public policy goals must be separated from the issue of costing. Attempting to incorporate the public policy objectives into costing confuses pricing and costing issues.

total revenues of the company are equal to the total cost/revenue requirement.[2]

Given the substantial level of common costs, the pricing of telecommunications services must be approached in a holistic manner rather than piece-part[illegible]. A Ramsey-type approach or a multipart tariff is appropriate.

Cost estimates and methodologies *by themselves* are of no use in addressing the issues of subsidization, predatory pricing, or protection of monopoly services from being allocated all the common costs of the firm. All of these issues involve the relationship of price to cost, so that none of them can be discussed without taking account of that relationship. This is the fundamental reason why I outlined the framework earlier. However, only costing issues should be addressed in the development of the costing approach, not the issues of pricing.

The first issue is the protection of "monopoly" service from being allocated all the common costs at the expense of "competitive" offerings. An efficient pricing scheme would *not* recover the common costs from just "monopoly services". Rather in determining the prices for all services, the common costs would be recovered from the array of services *roughly* in inverse proportion to the elasticity of demand for each service. This is the familiar Ramsey-pricing solution. All services would make a contribution to the shared and common costs of production and the degree of contribution would be determined by the demand characteristics of purchasers for each service. Therefore, while all services would be making a contribution

---

[2] Even a non-regulated firm will have a "revenue requirement" in the sense that investors have expectations of earnings which the firm must satisfy in light of the riskiness of the markets served.

toward the shared and common costs of the firm, those services with the least elastic demand would initially make a greater contribution.

[*5*] The type of pricing structure and price levels recommended promote competitive entry on a dynamic basis.

If the Commission attempts to limit the price increases on the lesser elastic services, it limits the market forces which will increase the firm's elasticity over time. Since market entry is determined in large part by the profitability of the market, by holding down the price for those services, the Commission is limiting the incentive of new firms to enter the market. Further, since one of the principle determinants of the price elasticity of demand faced by an individual firm is the number of firms offering similar products, this restriction on entry places downward pressure on the elasticities. One is led to the conclusion, therefore, that following the precepts of optimal departures from marginal cost pricing, will lead to (1) a case of increasing competition in those services where demand is currently more inelastic as the price rises and (2) that the level of contribution obtained from the mix of "competitive" and "monopoly" services will tend to equality at the margin over time. In working through the dynamics, it would be expected that the percentage of contribution coming from "monopoly services" would decrease over time while the percentage of contribution from "competitive services" would increase. In any event, in virtually no case would "monopoly services" be assigned the burden of all shared costs or vice versa.

I am recommending reliance on Ramsey-type rules for pricing, or other second-best approaches. GTE does not currently have information on elasticity of demand for every service; however, it has information on the demand

characteristics of many services indicating the directions in which relative prices should be moved. Such elasticities are clearly different across services currently offered.[3] While it is true that the use of the inverse elasticity rules can be gainfully employed to establish relative price levels of the various services, I would recommend that multipart price structures be employed as the primary [*6*] pricing mechanisms, rather than strict reliance on the inverse elasticity approach. In such a rate structure, the price of the marginal unit would be set at or very close to the incremental operating costs while the inframarginal prices would be priced higher to cover the other costs of the service. Such a price structure improves the economic welfare gains derivable from uniform inverse-elasticity (Ramsey) pricing, since the marginal price is set much closer to the marginal cost of a service. This non-linear multipart rate structure may be thought of as a declining block pricing plan for a service. In addition to generating revenues sufficient to cover the joint and common costs of the firm, this non-linear structure can readily reflect the notion of "avoided costs." Retail customers are likely to be smaller volume customers relative to wholesale customers. Accordingly, the price difference between the first and last block can incorporate the net avoided costs. Even in the non-linear multipart rate structure, however, the price elasticities of demand must be taken into account when pricing a service subject to economies of scope or scale. The important fact in this proceeding, however, is that both

[3] It is often argued that since elasticity estimates are not available on every service that Ramsey is not implementable. Ramsey is a very useful conceptual idea and information on price elasticities are available on numerous telecommunications services. In any event, making assumptions such as the application of uniform mark-ups is clearly inappropriate given the existing knowledge of price elasticities.

approaches involve departures from strict reliance on pricing at incremental cost in order to cover the common costs of the firm.

Within the context of a multi-product firm characterized by economies of scope and scale, one must also deal with the issue of how to handle common costs among services. To allocate the costs *ex ante* is only required if one believes in something akin to an FDC methodology. Thus, my opinion is that no allocation of common costs is or should be required on an *ex ante* basis. At the same time, **the total costs of the firm must be recovered.** The mechanism to do so is in the pricing of the service, not in the costing of a service.

As pointed out previously, the second fundamental purpose of any price is to distribute the costs among the customers of the firm. I have indicated how to address the issue - by an approximation of the inverse elasticity rules or by the use of a multipart rate structure. In so doing, the *ex post* allocations of the joint and common costs would be determined, in part, by the competitive nature of the service as reflected in the firm's price elasticities of demand. To the extent that constraints on the process are required to meet social or public policy objectives, then a second-order constrained price determination process could be [*7*] conducted following the same methodology. The resulting distribution of contribution to the joint and common costs of the firm will be roughly inversely proportional to price elasticities of demand for the services. To the extent that constraints are placed on the process, the contribution levels will not be strictly proportional, but will depend upon the services constrained.

The costing requirements set forth in the 1996 Act contemplate prices which are necessarily greater than either LRIC or TSLRIC.

The Telecommunications Act of 1996 ("Act") in Section 252(d) calls for the pricing of interconnection and network elements to be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)." In addition, this Section specifies that these prices will be "nondiscriminatory" and "may include a reasonable profit." While TSLRIC is a very reasonable starting point for the development of such prices, it is not adequate to recover joint and common costs. Indeed, since the 1996 Act specifies that a reasonable profit may be included, any price must make at least some contribution to the joint and common costs of the firm in excess of TSLRIC before profit levels can even be considered.

I urge the Commission to adopt eight principles to be applied to cost studies.

To be consistent with the 1996 Act's requirements with respect to the cost-basis, I believe there are eight (8) major factors the Commission should consider in evaluating whether to endorse a given costing standard: (1) the nature of the total cost function for a telecommunications company; (2) the distinction between short run cost functions and long run cost functions; (3) the treatment of service specific common and or fixed costs; (4) the relevant incremental costs; (5) the separation of pricing and costing; (6) considerations of market structure and degree of competition; (7) utilization of the most efficient

technology; and (8) reconciliation to company-specific revenue requirement.

The long run total cost function of the firm shows the relationship of the total costs of the firm to the mix and level of outputs, given the most efficient technologies that are representative of the firm's and [*8*] forward-looking costs. Thus a cost function is a causal relationship based on the underlying production function. Even in a long run specification, there may exist common or up-front costs which do not vary with the outputs of individual services, but do vary with the offering of a specific service or group of services. In the case of multiproduct firms which produce their output in variable proportions, as in the case of telecommunications, it is possible to derive separate long run incremental costs estimates for each specific product, holding all other outputs constant. Thus there will be an incremental cost curve for any one product, corresponding to each possible output of the other product or products. This incremental cost function will specify the costs which vary with output as well as any service-specific fixed costs which vary with the offering of the service. However, in a multiproduct firm, there is no counterpart to the single product firm's average cost. Where joint and common costs are present in the long run total cost function, any allocation of such costs to one product among the set of products supplied is irrational in the sense that it does not reflect cost causation. If price is set on the basis of such an arbitrary allocation, too little of the product may be produced. Correspondingly, too much of other products may be demanded if other prices are set too low based on the misallocation of the common costs.

To the extent that in the long run there are common costs associated with the application of the forward-looking technology, they will be included in the total cost function. Further, to the extent that the underlying production function is

characterized by discontinuities, e.g., lumpy capacity investments, the resulting cost functions, both total and incremental will also display discontinuities. Even in the long-run, there will be costs to provision a specific service which occur in a discontinuous manner; that is, there will be costs which do not vary with the level of output of that service, but do vary with the offering of the product. These are the long-run service-specific fixed costs. It is also possible and indeed likely that there will be up-front costs, also referred to as common service-specific fixed costs, that are ***causally*** related to the provision of a number of products. While such costs can be attributed on a causal basis to the provision of the set of products, even in the long run, no allocation of the common costs to the individual products can be made on a causal basis.

INITIAL COMMENTS OF THE PUBLIC UTILITIES COMMISSION OF OHIO (PHASE I)

* * *

[*47*]

The FCC seeks comment on how, if rates are to be set above LRSIC, to deal with the problems inherent in allocating common costs and any other overheads. Additionally, the FCC seeks comment on whether it should limit rates to levels that do not exceed stand-alone costs. NPRM at ¶ 130.

The PUCO, like the FCC and other states, has been seeking a solution to this dilemma for some time. The PUCO recognizes that setting interconnection prices and unbundled network element prices at a level which allows the ILECs recovery of all common overhead cost without regard to allocation will keep the ILECs "whole" and will likely prohibit competition. On the other hand, affording the ILECs recovery on the basis of a specified allocator of common overhead costs will likely provide prices set at a level to entice competition, at the same time incenting the LEC to lower its common overhead cost by becoming more efficient or to recover its common cost by pricing above its cost floor for competitive end user services. The PUCO has adopted a common overhead allocation policy that requires LRSIC plus a 10% adder, as well as joint costs to be reflected establishing a price floor for competitive service offerings.

As discussed above, stand-alone cost studies are an analysis of embedded costs and embedded decisions. These types of studies are hypothetical situations that analyze each offering as if it were the firm's only offering. While the PUCO Staff does not disagree with the notion of capping the prices of certain service offerings, it does not agree that a stand-alone methodology appropriate for capping rates. Stand-alone cost

studies are burdensome to conduct. See the PUCO's Staff comments on NPRM ¶ 233 for a discussion of capping rates on the basis as an imputation test and the [*48*] relationship between pricing for transport and termination of traffic and unbundled network elements.

COMMENTS OF THE PUBLIC UTILITY COMMISSION OF TEXAS

* * *

[*26*]

45. The Notice seeks comments on whether prices for interconnection and unbundled network elements should recover embedded costs or universal service costs.[81] As discussed previously, the Texas PUC firmly believes that regulators cannot begin to answer pricing questions until incremental cost studies on unbundled network elements are completed and we more precisely quantify the disparity between embedded and incremental costs. States must be allowed the discretion to determine, after appropriate review and consistent with state policies, the extent to which costs such as those described in these sections should be included in specific prices.

---

[81] Notice, paras. 144-145.

COMMENTS OF THE
UNITED STATES TELEPHONE ASSOCIATION

* * *

[*40*] overhead, and the like that are necessary to run the firm as a whole, which are not incremental to any individual service or to any specific group of services, but are incurred so long as the firm is operation at all. Hausman Aff. ¶ 8.

(d) Total costs should reflect actual, embedded costs. Even accounting for all forward-looking costs is not a sufficient measure of total costs. Embedded costs due to past investments in the network must also be recovered. Networks evolve over time and will never contain only the very latest technology. Yet the LECs have incurred substantial costs in building the existing infrastructure and should not be saddled with ex-post facto regulatory revisions that bar prices that recover those legitimate costs. Hausman Aff. ¶¶ 10-15. If new competitors want to use the LECs's embedded plant, then they should pay for the embedded plant, not for some ideal network that they are not using, that doesn't exist, and that will never exist.

Although the Act prohibits regulators from engaging in rate-based proceedings to determine embedded costs of incumbent networks, it does not limit recovery only to forward-looking costs. See S. Rep. No. 23, 104th Cong., 1st Sess. 21 (1995) (reference to "rate of return or other rate based proceeding" describes a type of regulatory proceeding, not a pricing methodology). Section 252(d)(1) simply refers to "cost," without any restriction to forward-looking costs. Such a limitation would, moreover, be incompatible with Section 252(d)(1)(B), which allows recovery of a reasonable profit margin.

[*41*] (e) Precluding LECs from recovering total costs would create incentives for inefficiencies. In addition to being incompatible with the Act, if the Commission set a price ceiling that generated revenues below total costs, it would provide incentives for inefficient investment. Hausman Aff. ¶¶ 11-12. Such rates will deter LECs from undertaking investments to improve the network because of the considerable risk that costs will not be recovered. Unless regulators permit rates that compensate LECs for investments in their networks, LECs will rationally invest less than would be socially optimal. On the demand side, when prices are set too low entrants will overconsume interconnection and network elements from the incumbent LEC and underinvest in their own facilities, and inefficient firms will be able to enter the market. Prices set only at incremental cost, for example, allow entrants to provide service over the LEC's network without having to bear the joint, common or embedded costs that would arise if competing facilities were built. This result is inefficient and contrary to the Act's purpose of promoting the emergence of facilities-based local competition. The Commission has already recognized that "low charges for interconnection with LEC facilities . . . would give interconnectors false economic signals that could stimulate uneconomic entry." Special Access Interconnection Order, 7 FCC Rcd at 7429 n.291.

(f) Precluding LECs from recovering total costs would be confiscatory. Rate regulations that prevent LECs from recovering their costs or providing interconnection and unbundled elements are [*42*] also confiscatory, and as such are subject to scrutiny under the Takings Clause. See Duquesne Light Co. v. Barasch, 488 U.S. 299, 308-10 (1989) ("If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."); FPC v. Hope

Natural Gas Co., 320 U.S. 591, 602 (1944) (to avoid being confiscatory rates must allow carriers to earn returns sufficient to attract investors). Restricting LECs to rates that cannot generate revenues sufficient to cover total costs on LEC investments will lower returns and reduce their ability to attract new capital.

Moreover, rate regulations that fail to account for joint, common and embedded costs would interfere with the expectations on which LECs have based past investment decisions. Decisions about how much switch and loop capacity to build required assessments not only of future revenues to be earned from those facilities but also of the investments required to meet regulatory requirements. For the Commission to decide now, long after those costs have been sunk, to bar compensatory returns undermines the LECs' legitimate, investment-backed expectations. Interference with property rights in a manner that undermines such expectations constitutes a taking. Penn Central Transp. Co. v. New York City, 438 U.S. 104, 124 (1978).

Any interpretation of the Act that effectuates a taking will not survive judicial review under established principles of administrative law. It is well settled that, "[w]ithin the bounds [*43*] of fair interpretation, statues will be construed to defeat administrative orders that raise substantial constitutional questions." Bell Atlantic Tel. Cos. v. FCC, 24 F.3d 1441, 1445 (D.C. Cir. 1994); see also, Rust v. Sullivan, 500 U.S. 173, 190-91 (1991). Indeed, where property rights are implicated, a fair reading of the statute must provide a "clear warrant" for the agency's authority to take property. Bell Atlantic, 24 F.3d at 1446. The 1996 Act provides no such warrant and is more naturally read to precluded the Commission from establishing below-cost rates.

(g) A reasonable profit means a positive profit, not just a return on capital. Profit is the excess of the firm's total revenues over the firm's total costs, taking into account all costs including the cost of capital. The cost of money to purchase capital assets is a necessary component of incremental costs, joint and common costs, and embedded costs. A firm that merely recovers all those costs, including the cost of capital, has not earned a positive profit. Without the potential for a positive profit, investors would have no incentive to risk their capital in building new plants and facilities, and the public interest would suffer because consumers would be deprived of the benefits of such facilities. Hausman Aff. ¶¶ 12-13.

(3) Rate Levels.

(a) LRIC-Based Pricing Methodology. For the reasons given above, the Commission should not set a ceiling on prices for interconnection and unbundling that does not allow the LECs to recover the incremental, joint and common, and embedded [*44*] costs of their networks, as well as a reasonable profit. It follows that two cost measures on which the Commission has sought comment, LRIC (long-run incremental cost) and TSLRIC (total service long-run incremental cost), cannot appropriately serve as rates for network elements or interconnection. LRIC could serve as a price floor only in the context of voluntary price negotiations or when pricing in response to competition. LRIC cannot be mandated by a state commission or the FCC because it does not allow recovery of total costs.

(i) LRIC. LRIC is the long-run cost of providing a specified additional quantity of a LEC's service or, alternatively, the amount a carrier saves by dropping that incremental quantity of service. LRIC does not account for the fixed or underlying costs of providing the service on the network. These fixed or "lumpy" costs of providing the service

are incurred regardless of whether a few customers more or less are served. Thus, a price set at LRIC would not even cover the costs of the particular service and would make no contribution to the joint costs of facilities shared with other services, the common costs of the network as a whole, or embedded costs. Hausman Aff. ¶¶ 10-13.

The Commission has itself recognized that LRIC is an inappropriate standard for mandated prices because such rates "will not recover the total costs of the network. Notice of Proposed Rulemaking, Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket 95-185, ¶ 48 (released Jan. 11, 1996) ("LEC-CMRS Interconnection Notice"). See [*45*] also Special Access Interconnection Order, 7 FCC Rcd at 7429 n.291 ("it would not be reasonable to require the LECs to base [expanded interconnection] charges on the direct costs of those services, with no loadings for overhead costs"). If LECs can only charge entrants incremental costs, they must recover the fixed costs elsewhere, such as through increases in retail rates. But because the entrants do not have to bear the fixed costs, they can undercut any retail price increases made by the LECs and take the LECs' customers. This distortion deters entrants from making efficient investments in facilities and deters the LECs from developing new services. Thus, LRIC alone cannot be the basis for legally and economically sound pricing of interconnection or unbundled network elements.

LRIC may be useful as a price floor, however, to prevent anticompetitive or predatory pricing. As competition increases, LECs will need to respond to the prices set by new entrants who have built their networks from scratch, using the latest technology, and are not burdened by the LEC's historical costs. As long as prices are set above LRIC, the LECs will still be able to compete for this business and make a contribution to their embedded costs. Thus, a price floor set at LRIC gives LECs the

flexibility to respond to competitive conditions, while still ensuring that the marginal costs of the service in question are covered so that the LEC's prices are not predatory. Hausman Aff. ¶ 13.

(ii) TSLRIC. TSLRIC captures the costs that would be saved by the LEC if it did not provide the [*46*] entire service in question. Accordingly, TSLRIC may capture the "lumpy" costs of providing a particular service. That is to say, TSLRIC includes service-specific fixed costs (non-volume-sensitive costs), while LRIC typically holds these costs separate from volume-sensitive costs. But if a service uses facilities that support other services, TSLRIC will still not cover joint and common costs or embedded costs, much less provide for a reasonable profit. Hausman Aff. ¶¶ 10-11.

Prices set at TSLRIC would therefore be inconsistent with the Act's requirement that the LECs be permitted to recover their total costs plus a reasonable profit. Prices set at TSLRIC would also distort the LECs' technology decisions. When a LEC can use the same facilities to support several distinct services, economies of scope are realized. Inputs can be shared instead of being installed separately for each service. Shared costs and facilities lower total costs for the firm by lowering the TSLRIC for each individual service that shares the joint facilities. If firms know that they can recover the costs of those shared facilities (which costs, as shown above, are not captured in TSLRIC), then they have incentive to seek efficient, shared technologies. On the other hand, if joint costs are not recovered because prices are constrained in TSLRIC, the firm's incentive is to find technologies with low shared costs but higher incremental costs. Such technologies are less efficient, but if a firm is required to operate under these constraints, they are a rational response if the firm is to recover its costs. Hausman Aff. ¶ 11.

[*47*] (iii) The MCI and AT&T Models.
The ex parte models presented to the Commission that advocate TSLRIC as a rate constraint are unrealistic and incorrect. In particular, the Hatfield model of TSLRIC pricing, submitted on behalf of MCI, would lead to massive under-recovery. As an initial matter, the study assumes that LECs provide services to entrants "in the ways the best available technology allows."[40] But a network is not rebuilt at each point in time to take advantage of improved technology. Instead, it is built bit by bit over time and encompasses multiple generations of technology. Although each investment decision may have been efficient and foresighted when made, the resulting network will not be identical to the one that could be built today if it were reconstructed under the best forward looking technology available.

As the Commission has explained, "where technological developments are reducing the costs of providing service, setting the price of discrete services equal to the forward-looking LRIC of each service is not likely to recover the historical, embedded costs of the network."[41] The Hatfield study wrongly suggests that "existing infrastructure . . . is irrelevant" and that the embedded costs of such infrastructure should not be recovered. Firms have [*48*] incurred substantial costs in building existing infrastructure and should not be saddled with ex-post regulatory revisions that bar prices that recover those legitimate costs.

---

[40] Hatfield, Assocs., Inc., The Cost of Basic Network Elements: Theory Modeling and Policy Implications at 16 (Mar. 29, 1996) ("Hatfield study")

[41] Notice of Proposed Rulemaking, Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket No. 95-185, FCC No. 95-505, ¶ 48 (released Jan. 11, 1996).

A rule that always reduces rates to the level achievable under the latest technology, as the Hatfield study recommends, will provide firms with strong incentives to underinvest and thereby cause losses in productive efficiency. Hausman Aff. ¶¶ 11-12. It will also be confiscatory and will produce an uncompensated taking of LECs' property. This is particularly important for small and mid-size companies that are still regulated under a rate-of-return regime. Those costs cannot suddenly and simply be ignored.

The Hatfield study acknowledges that its estimate of the total economic cost of unbundled network elements amounts to only 44% of the LECs' existing revenue requirements (at 35). The study furthermore concedes that the embedded costs of past investments not captured by TSLRIC amount to over $17 billion -- at least 20% of current revenue requirements -- and acknowledges that the model does not capture all of the LECs' actual overhead expenses (at 36, 43). These gaps indicate that TSLRIC-based prices will fail to capture anything close to total costs. The study glibly tries to explain away the gap with the unsupported assertion that the LECs are inefficient and with nonspecific collateral attacks on the Commission's policies and the past decisions of more than 50 regulatory agencies in thousands of proceedings. Such vague, after-the-fact attacks supply no basis for preventing the LECs from [*49*] recovering the embedded costs and overhead expenses of operating their networks.[42]

---

[42] The Supreme Court has traditionally held that a utility should be compensated "for all prudent investments at their actual cost when made (their "historical" cost) irrespective of whether individual investments are deemed necessary or beneficial in hindsight"). Duquesne Light Co. v. Barasch, 488 U.S. at 309; see also Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923). See also Daniel F.

(continued...)

AT&T's proposal has similar flaws. AT&T acknowledges that "TSLRIC pricing of services that share fixed facilities may, under some circumstances, result in large-scale under-recovery of facilities costs." AT&T Ex Parte submission of 50 (FCC Mar. 21, 1996). AT&T accordingly proposes using the TSLRIC of adding an element or facility to the network instead of a service. Id. at 47-50. To the extent an element or facility supports multiple services, TSLRIC of that element or facility may capture more joint costs than TSLRIC calculated on a service basis. Nonetheless, AT&T does not dispute that its version of TSLRIC still leads to underrecovery of common and historical costs. Id. at 50.

In short, neither LRIC nor TSLRIC can provide an adequate level for prices set by the Commission. Rather, LRIC can serve only as a floor for rational, cost-based pricing. LRIC cannot be mandated. Even using LRIC as a floor, moreover, the Commission should not itself attempt to quantify LRIC for interconnection and unbundled network elements. Trying to establish LRIC for services across LECs based on a single cost study would fail to capture [*50*] differences in cost structures among firms or geographic regions and would lead to a contentious battle over which study to use. Such a straightjacket would be particularly hard on rural LECs and, in some instances, LECs eligible for the two percent waiver process under Section 251(f). Their costs vary markedly and are likely to be substantially higher. Thus, a ceiling approach is inappropriate for these LECs.

---

[42] (...continued)
Spulber, Regulation and Markets 610 (1989) ("Perhaps the most important aspect of the regulatory bargain is the ability of regulators, customers, and the regulated firm to make commitments both to pricing policies and to irreversible investments").

(b) Rate Proxies.

Given the administrative difficulty of establishing rate guidelines based on formulas, the Commission has asked for comment on the alternative of setting rates by proxy. Proxies may, indeed, be a feasible way to establish presumptively valid rates for some unbundled elements. But the Commission needs to proceed with great care here in defining the elements and establishing the proxies to avoid arbitrage by interexchange carriers seeking to avoid paying access charges prior to general access charge reform. It is important, moreover, that any proxies not be established as rate ceilings; at most, they can serve to indicate levels below which rates will be presumptively valid and above which they must be further justified. Placing a rigid, proxy-based cap on rates will lead to undercompensation in some instances, depriving LECs of their legitimate right to cost recovery. It will also deprive state commissions of the regulatory flexibility guaranteed to them by the new Act and by Section 2(b) of the 1934 Act, which was not amended by Congress and which deprives the Commission of jurisdiction to set rates for intrastate services.

[*51*] Paragraph 139 of the NPRM suggests using interstate access charges, less CCLC and RIC, to measure certain rates. But the Commission has misconstrued the unbundling process if it believes that interstate switched access is an adequate proxy for all unbundled elements priced under Section 252(d)(1). In particular, unbundled local switching (i.e., the port concept described above) includes different functionalities from the local switching component of interstate switched access. As a proxy for unbundled local switching, the Commission would have to combine a number of elements from existing state and federal tariffs, with appropriate adjustments.

Switched access charges could be a proxy, if at all, only for the transport and termination of traffic under Section

252(d)(2). As explained below (pp. 58-66, infra), interexchange carriers should not, must not, be permitted to buy network unbundled elements as a substitute for access. Otherwise, interexchange carriers will have a strong incentive to avoid access charges by buying unbundled network elements and reconstructing access, particularly if both CCLC and RIC are excluded from the proxies for those unbundled elements.

CCLC and RIC reflect genuine costs incurred by LECs. Currently, these charges are born by interexchange carriers in the switched access charges the pay to LECs. If those charges are excluded from the rates paid by new entrants for unbundled elements, and the unbundled elements could be reconstructed to [*52*] replace access, then a significant danger of arbitrage would be created.

To avoid such arbitrage and treat all providers equally, the Commission should eventually move to a system in which all interconnectors -- IXCs, CMRS providers, CLECs, ESPs, etc. -- pay common prices for common services. But such a result will require a completion of access charge reform and a new model for ensuring universal service. Ideally, the Commission would complete those reforms at the same time that it completes this rulemaking. Since that appears impractical, however, the Commission has a fundamental choice to make in the meanwhile. It must either include CCLC and RIC in the prices paid by new entrants or it must rigidly police the boundaries between interexchange access and unbundled network elements. If it eschews the former but neglects the latter, then the LECs will be left with a huge shortfall as IXCs game the system to avoid paying access charges. Moreover, the IXCs, having gained their advantage through arbitrage, will then have little incentive to cooperate with access charge reform and universal service reform. What the Commission should do, in the meanwhile, is restrict the use of unbundled elements to the loops and ports and various forms

of dedicated transport needed to provide local service, not including anything corresponding to switched access for interexchange carriers. Switched access should be a proxy only for reciprocal compensation for the transport and termination of local traffic under Section 252(d)(2). And even that proxy should [*53*] include both CCLC and RIC until the Commission has completed its work on access reform and universal service.

With respect to true unbundled elements, the special access tariff for a voice grade local channel may, in at least some instances, provide a potentially useful proxy for an unbundled local loop.[43] An unbundled loop does not terminate at the LEC switch. Rather, it is provisioned and maintained in a manner that is more analogous to a special access dedicated line than to a regular switched exchange line. As far as the LEC's network is concerned, this is a non-switched facility. In appropriate circumstances, pricing of dedicated, nonswitched facilities at the current special access tariff has a number of advantages, such as preventing tariff shopping and permitting competitors to choose loops other than 2 wire voice grade channels.

Again, however, any such proxies have to be handled with care. Local loop costs will vary widely from area to area depending on population density and other factors. Indeed, some rural areas have monthly local loop costs approaching

---

[43] Alternatively, the Commission has acknowledged (NPRM ¶ 141) that CCLC and SLC together recover the 25% of local loop costs. Proxies for unbundled looks could therefore be based on a multiple of the CCLC plus the SLC.

$100.[44] A grave threat [*54*] to universal service would be posed if the Commission established too low or too rigid a proxy for local loop costs.[45]

The Commission must also recognize that some unbundled elements (such as databases) have no counterparts in access charges. Here, the Commission should either eschew proxies altogether or, again, look to existing state and federal tariffs for appropriate analogues for these elements.

Special pricing rules are appropriate for rural LECs and those LECs that are eligible for the waiver process specified under Section 251(f). For some of these LECs it would especially logical and expedient to use current access charges, including flat-rated elements, to derive interim prices for interconnection and unbundled elements where possible. This would serve several purposes. First interconnection arrangements could be quickly negotiated since existing prices (i.e., access charges) would be in place. Small and mid-size incumbent LECs could otherwise be burdened with producing cost studies that could bog down the [*55*] interconnection

---

[44] Comments of the United States Telephone Association, Federal-State Joint Board on Universal Service, CC Docket No. 96-45 (filed Apr. 12, 1996).

[45] The September 1995 Benchmark Cost Model (BCM) submitted to the Commission (for CC Docket No. 80-286) by MCI, NYNEX, Sprint and U.S. West does not provide an appropriate proxy for local loop costs. The BCM model was designed only to identify "high cost areas," not to provide an accurate estimate of the costs to serve each Census Block Group included in the model. The Hatfield version of that model is even more inappropriate because it is based on an idealized, optimal network that simply doesn't exist. It does not capture embedded costs and therefore has nothing to do with the real costs of LEC networks. The BCM model does, however, reinforce the fact that costs will differ substantially, census group by census group, depending on population densities.

negotiation process.[46] Second, migration in interconnection pricing would automatically track with changes in the access pricing regime. Finally the cost recovery contemplated by the 1996 Act is largely incorporated within current access prices.

(c) Other Issues.

USTA has already explained in detail why LECs should be permitted to include their embedded costs in the total costs to be recovered in charges for interconnection and unbundled elements. See supra pp. 40-43. The Commission seeks comment on the "empirical magnitude" of the embedded costs that would not be recouped if a solely forward-looking pricing methodology were used. A variety of estimates have been placed on these costs, ranging from $13 billion to as much as $18.4 billion. See, e.g., Mike Mills, Phone Firms Seek Higher Local Rates, Washington Post, A1 (May 7, 1996) ($13 billion); Hatfield study at 36 ($17.65 billion); AT&T, MCI, LDDS, WorldCom, Comtel, Interconnection, Unbundling and Access: Creating FullService Competition Under the Telecommunications Act of 1996 at 3 (Mar. 1996) ($18.4 billion).

Whatever the actual amount, these are perfectly legitimate embedded costs. They have been properly incurred pursuant to regulatory oversight, and regulators must permit them to be [*56*] recouped. Indeed, if the Commission does not permit the LECs to recover a proportionate share of such amounts in charges for interconnection and unbundling the embedded costs attributable to those services will have to be

---

[46] Administrative convenience looms large for small and mid-size LECs since the volumes of interconnecting traffic and the demand for unbundled elements from such LECs is likely to be low, particularly at first, as new entrants target the larger and more lucrative urban areas. However, the option of producing cost studies should be left to their discretion.

recouped elsewhere. This would throw large amounts of costs onto the states and create pressure to raise local rates to permit full cost recovery by the LECs.

The Commission would thus place itself in an extremely vulnerable legal and political position if it does not permit the recovery of embedded costs under Sections 251 and 252. After supplanting the states' authority to determine just and reasonable rates under those sections, the Commission would then set rates that force the states to make up the shortfall elsewhere. If anything, those who purchase interconnection and unbundled access from the incumbent providers of last resort should make a contribution to universal service (along with paying the total costs of what they are buying), see § 254(b)(4); such carriers certainly should not themselves obtain a subsidy (by paying less than total costs) which detracts from universal service by forcing an increase in local rates.

(4) Rate Structures.

Within the rate-setting guidelines established by the Commission, the particular structure of rates should be left to private negotiation and state review. The Commission should not prescribe restrictive rules narrowly specifying the structure of rates for particular network elements. Among other things, such rules might interfere with the ability of parties to tailor [*57*] interconnection packages to particular entrants' needs.

FEDERAL IMPLEMENTATION OF THE TELECOMMUNICATIONS ACT OF 1996: COMPETITION IN THE LOCAL EXCHANGE

A Report by Robert G. Harris and Dennis A. Yao

May 16, 1996

Prepared for US WEST, Inc.
CC Docket No. 96-98

A. INTRODUCTION AND EXECUTIVE SUMMARY

The ultimate goal of the Telecommunications Act of 1996 is to ensure a wide range of high quality, low-cost readily available, technically advanced telecommunications services for American consumers, business enterprises, schools, hospitals, government agencies and non-profit organizations. This goal can only be achieved by promoting investment and continuous technological progress in the nation's communications infrastructure: it can not be achieved merely by allowing competitors to buy existing network facilities on an unbundled basis or by reselling existing services bought from local exchange carriers on a wholesale basis. It is therefore imperative that the Commission adopt rules in this proceeding that promote efficient competition; facilitate the innovation, deployment and adoption of new technologies and services; and provide adequate incentives for expanding investment in the nation's telecommunications and information infrastructure. Conversely, it would be directly contrary to these policy objectives for the Commission to adopt policies that encourage inefficient entry, distort the competitive process by creating or enlarging artificial advantages of some competitors, or reduce the incentives for innovation and investment by incumbent and potential new service providers.

The appropriate policies for the transition to full competition should recognize the important role that U S WEST and other LECs will continue to play in that transition. Over the past decade, investments by local exchange carriers have been essential to the development of competition in interexchange services. For example, without substantial investments in improved switching capabilities, there would have been no "equal access" for IXCs. To promote equal access, this Commission specifically adopted policies that provided the stream of revenues required to fund those

investments. The Commission should not adopt policies requiring enormous investments by LECs, without ensuring the recovery of the revenues needed to cover the costs of those investments. For an interim period of several years, U S WEST and other LECs will provide key ingredients to the "network of networks," including a means of interconnection and interoperability across the rapidly growing number of competing and cooperating communications networks. Provision of these ingredients and continued investments [*2*] in the existing public telecommunications network will require enormous expenditures. Thus, it is crucial to the nation's interest in the communications infrastructure and in competition that U S WEST be allowed to compete on even terms.

As a matter of first principle, then, the Commission's rules should promote allocative, technical and dynamic efficiency. At all costs, the Commission should avoid policies that may create the appearance of competition - e.g., by increasing the number of competitors in local exchange services - but that, in the long run, actually inhibit real competition by creating conditions that ensure the success of a few large firms at the expense of many other potential competitors. Given the history of this industry, it is especially important that the Commission's rules do not recreate an industry in which one firm, such as AT&T, is allowed to dominate the marketplace. Yet, if the Commission were to adopt the policies advocated by AT&T, that would surely be the result. For example, if the Commission mandates that incumbents set the wholesale price of local exchange service below its full economic cost, as AT&T proposes, it runs the very real risk of creating an environment in which AT&T will dominate local exchange markets. Instead, the Commission should pay careful attention to the likely effects of its rules on the structure of future local exchange and other telecommunications markets, as these

markets will be powerfully influenced by the results of this proceeding.

It is critically important that the FCC's rules not distort competitive dynamics by favoring one class of competitor or one type of technology over others. With business units operating as (1) an incumbent LEC, (2) facilities-based new entrants (i.e., its cable companies), and (3) a wireless service provider in different jurisdictions, U S WEST has a particularly strong incentive to favor balanced competition so that its individual constituents can compete for local exchange business on their respective merits. Hence, U S WEST opposes policies that are biased in favor of either incumbents or entrants. A significant danger is that policies will be biased in favor of entrants, i.e., policies that promote "biased competition," but inhibit the development of efficient competition. To take one historical example, in surface freight transportation, regulatory policies greatly inhibited railroads from competing with motor carriers. Those policies caused enormous [*3*] inefficiencies and competitive distortions and literally drove many railroads into the ground. Only when many rail carriers were in bankruptcy did Congress and the Interstate Commerce Commission finally free the railroads from regulatory policies that had prevented them from competing with other modes of transportation. We certainly hope that the nation does not follow a similar path in telecommunications.

The Commission can increase the probability of success in local exchange competition by adopting the minimal set of rules necessary to ensure nondiscriminatory interconnection to the public switched network. Public policy remedies should be narrowly tailored to ameliorate the underlying economic problem they intend to address. The approach of tailoring the remedy to the problem is applied in antitrust and consumer protection law and policy, thereby avoiding unanticipated distortions in the market. By limiting its rules to those required

to establish conditions that will allow fair competition to flourish for the benefit of consumers, the Commission will enable an expansion of voluntary choices based on buyers and sellers negotiating and transacting in markets, rather than on regulatory imperatives and restrictions.

In so doing, the Commission should recall the central role of prices in a market economy. If the prices of telecommunications services - whether at the retail or wholesale level, of unbundled or bundled services - do not cover their full economic costs, neither incumbent LECs nor existing competitors nor potential new entrants will have ANY incentive to invest in network facilities. It is well understood that competition promotes efficiency by driving prices toward costs; it is worth noting, though, that efficient competition will not develop and cannot succeed if some firms are required to sell outputs at prices that are below cost. Thus, whatever rules are adopted to determine wholesale, network element and interconnection prices, it is imperative that those prices be based on the full economic costs associated with providing each service. Economically incorrect pricing will reduce or distort investment in new technologies and systems and bias customer choices.

In addition to economically rational pricing, promoting the nation's interest in advanced telecommunications services requires policies that provide incentives and rewards for innovation. [*4*] The Commission should establish clear ground rules for determining which services should be proprietary and therefore not subject to mandatory wholesale/resale requirements. Competitive players in telecommunications markets must be able to protect their innovations through patents, copyrights, trademarks and similar mechanisms, otherwise incentives for the investment in and development of innovative telecommunications services will be stifled.

Finally, the Commission, in establishing interconnection and competition policies, should recognize that it will be constrained in its ability to correct errors caused by "interim" policies. Public policies become treated as "entitlements." It should be assumed that policies intended to be transitional will become semi-permanent and difficult to modify. Experience suggests that there is a reasonably high likelihood that a policy designed to be transitory will outlive its value and ultimately may interfere with the original policy goals. One way to prevent this from occurring is by adopting policies now that are adaptive, self-correcting and market-based.

These are the issues addressed in this report. In Section B, we outline the contours of the current conditions in local exchange services. Assuming nondiscriminatory access to call termination, we note that the major barrier to efficient competition in local exchange services is not the market power of incumbents, but the regulatory obligations and restrictions imposed on the incumbents. In other markets, policy makers would be suspicious that prices set below costs were predatory and prices set well above costs constituted "monopoly" overcharges. Yet, in local telephone services, such pricing is seen as a virtue and is, in any case, compelled by current rate regulations.

We also distinguish, in Section B, the three main forms of entry into local exchange services: facilities-based (i.e., the entrant invests substantially in its own network); partial facilities-based (the entrant invests in its own network but also rents the use of unbundled network elements from facilities-based carriers); and resale (the entrant resells services purchased from a facilities-based carrier). We caution that while policies that enable entrants to rent unbundled network elements or resell the services of facilities-based carriers can promote competition, such policies can also [*5*] inhibit the

development of facilities-based competition by distorting entrants' "make or buy" decisions.

Section C addresses specific policy issues raised by the NPRM and offers comments on the policy choices facing the Commission and state regulatory authorities. We explain why only call termination, not other interconnection services such as transport and tandem switching, should be governed by the Commission. We iterate one of the most fundamental propositions of economics: that the prices of goods and services- including those designated as essential facilities or services - should be priced to recover their full economic costs. Thus, LEC prices should reflect the total service long run incremental cost (TSLRIC), shared and common costs, a reasonable profit, and, during a transition period, embedded costs. *Any costing standards or methodology used to set prices must, therefore, when applied to the entirety of US WEST's services, give US WEST an opportunity to recover its total costs.*

That principle should be consistently applied in telecommunications, in the pricing of retail local exchange services, in the wholesale pricing of local exchange servicing, in the pricing of unbundled network elements, and in the pricing of call termination. We further show why, given the complexities and alternative means of interconnection, no system of tariffed prices can possibly reflect all of the myriad variations in interconnection arrangements. Hence, private negotiations among the parties are the only conceivable method of achieving rational, efficient interconnection.

In Section D, we begin with a discussion of the interplay between telecommunications policies, the strategies of competitors and the likelihood of success in telecommunications markets. Our point is this: whether or not the Commission intends for its rules to affect competition dynamics - who wins and who loses - its rules surely will have

that effect. Recognizing that fact, the Commission should strive for policies that are competitively neutral, that allow competitors to succeed on their relative merits, and that do not magnify the inherent advantages of major players such as AT&T to make competitive survival difficult for the diversity of other potential players. [*6*]

To analyze the probable effects of alternative policy regimes, we construct and contrast the probable outcomes of two very different policy scenarios. In the "biased competition scenario," we assume that the LECs' retail prices are not restructured; wholesale prices are set below the cost of local exchange service (because they are established by discounts off of below-cost retail prices); excessive unbundling is required, with inadequate compensation to LECs for the cost of unbundling; and call termination and/or unbundled network elements are priced at or below incremental cost (e.g., by requiring "bill and keep"). The "efficient competition scenario" assumes instead the rapid adoption of economically rational retail pricing of exchange services through rate rebalancing; and prices of call termination, unbundled network elements and wholesale local exchange service cover full economic costs, reflect variations in costs, and enable LECs to earn a reasonable profit.

The expected outcomes of these two scenarios are quite different. By stressing unbundling and reselling over investment in facilities, policies that bias competition amplify the existing advantages of the major IXCs, facilitating their entry into local exchange services based on brand name and established customer bases. Customers' switching costs increase, reducing the vigor of price competition. Entry by smaller players is made more difficult, now and in the future. Investment in marketing and advertising is encouraged and rewarded, investment in new technologies, new services and local exchange facilities are discouraged.

Policies that promote efficient competition, in contrast, are likely to increase the dynamics of competition and the diversity of competitors. Efficient entry and innovation in technology and services are rewarded. The source of market success - and thus the grounds of competition - lie less in marketing than in offering better services at lower prices. Resale and unbundling would serve as complements to - rather than substitutes for - facilities-based competition. Hence, policies that promote efficient competition will promote investment in the nation's telecommunications infrastructure by the most efficient service providers. The Commission should be careful that the environment created by its final local competition rules emulates the [*7*] "efficient competition scenario" and not the "biased competition scenario" suggested by some provisions in the NPRM.

REPLY AFFIDAVIT OF WILLIAM J. BAUMOL, JANUSZ A. ORDOVER, AND ROBERT D. WILLIG

1. We are pleased to note that the ILECs' economist affiants take positions that make convergence among our views possible. As Dr. Crandall puts the most fundamental point, "From an economic standpoint, the pricing of any network function, whether for termination, interconnection, or any other purpose, should be based on long-run incremental costs." Crandall, p. 11. Drs. Beauvais, Harris & Yao, and Hausman also acknowledge, to varying degrees, the soundness of basing prices on TSLRIC. Beauvais, pp. 2-4; Harris & Yao, p. 5; Hausman, pp. 2 & 3. These economists, however, raise several issues that urgently require further exploration, because if not cleared up, they can lead to policy measures that impede competition and economic efficiency. We comment on each of these matters in turn.

I. TSLRIC-BASED PRICING IS FULLY COMPENSATORY.

2. The ILECs' affiants contend that "pure" TSLRIC pricing, by excluding costs that are common to or shared by multiple network elements, would prevent full recovery of forward-looking costs and discourage efficient make-or-buy decisions. Beauvais, pp. 4, 7, 9-13; Harris & Yao, p. 18; Hausman, pp. 4-5. Neither we nor AT&T have proposed LRIC or "pure" TSLRIC (e.g., ignoring shared and common costs) pricing at the individual network element level, however. Although we are skeptical that significant common or shared costs exist, we agree that prices for individual network elements should permit the recovery of any significant forward-looking, efficient shared or common costs incurred in providing network elements, subject to a stand-alone cost ("SAC") ceiling and an

imputation rule. These constraints allow ILECs to recover *all* of the costs that a competitive market would allow efficient firms to recover.

[*2*] 3. Drs. Harris, Yao and Hausman also contend that prices above TSLRIC are necessary to permit full recovery of future investment by ILECs in the face of technological change and obsolescence. Harris & Yao, p. 19; Hausman, pp. 6-7 & n. 4. This contention betrays unwarranted pessimism about TSLRIC pricing and the performance of competitive markets. The semiconductor, disk drive, fiber optic, and telecommunications equipment industries are only a few of the many capital-intensive industries in which intensely competitive prices have coexisted with rapid innovation. Prices in competitive markets reflect the forward-looking costs of the most efficient technology that is *generally available*, not experimental prototypes and proprietary initiatives to outdo rivals. The impetus for an individual firm to adopt an innovation is the prospect of above-average returns, however temporary, from bettering generally available technology. While the payoff from an innovation erodes with its diffusion over time, a competitive market provides a stream of revenue that is exactly sufficient to recoup the necessary investment over the economic lifetime of the pertinent assets if the actual rate of technological change (and other market conditions)

match expectations.[1] The value of that revenue stream equals TSLRIC - - not TSLRIC-plus-a-markup.[2]

[*3*]

II. EMBEDDED COST ADDITIVES ARE UNJUSTIFIED.

4. Some affiants argue that prices for network elements should be permitted to exceed TSLRIC by a margin wide enough to provide full "recovery of the embedded costs incurred to meet regulatory service obligations" in the past. They suggest that such a recovery is required by an implicit regulatory bargain or compact between the ILECs and their regulators that stems from the failure of past depreciation charges to keep pace with the diminution over time of the present value of the expected income stream from the ILECs' existing assets. Breaching such a bargain, the ILECs argue, would discourage them from making efficient levels of

---

[1] *See, e.g.*, William J. Baumol, "Optimal Depreciation Policy: Pricing the Products of Durable Assets," 2 *Bell J. of Economics and Management Science* 365-76 (Autumn 1971). Unexpectedly fast or slow technological change, like any other after-the-fact departure from expected market conditions, can cause the actual return on any particular investment to exceed or fall short of expectations. On average over time, however, actual returns on investment should closely approximate expected returns.

[2] Dr. Hausman's further claim that TSLRIC pricing would deny ILECs a "reasonable profit" because "fixed and sunk" costs incurred in the future "will not be counted in the forward looking costs of a LRIC study" (Hausman, pp. 7-8) confuses short run and long run costs. TSLRIC, as its name indicates, is a long-run cost measure: it assumes a time period long enough so that all sunk investment must be replaced. The cost of efficient additional investment in long-lived assets needed to produce network elements is properly included in TSLRIC *even if some or all of the investment will become sunk once put in place.*

investment in the future. Harris & Yao, p. 20; Hausman, pp. 4-6.

5. As an initial matter, the suggestion that levels of stranded plant could ever be measured simply by comparing the ILECs' current accounting cost-based revenue requirements with the TSLRIC of providing unbundled network elements is plainly wrong. There are any number of reasons why those figures would diverge. Most fundamentally, for example, large portions of the difference may reflect the very inefficiencies, overearnings, cross-subsidies, and imprudent investments that the competitive market model is designed to drive out. To allow concern over the ILECs' prospective inability to recover such "costs" to prevent or delay efficient pricing would be anticompetitive, inefficient, and contrary to the spirit of the 1996 Act. Thus, even if a regulatory bargain were pertinent here, the costs at issue would be limited to the costs in investments that (1) were prudently made and necessary to provide the network elements at issue, (2) have not been depreciated as rapidly as warranted by the diminution in the earning power of the assets, and (3) cannot be mitigated.

6. The ILECs have not shown that these conditions hold. Indeed, the empirical analysis reported by AT&T witnesses Selwyn and Kravtin indicates that any such costs of obsolescence [*4*] are small. *See* Reply Affidavit of Selwyn and Kravtin.

7. We also understand that existing ILEC networks have been greatly overbuilt for present or foreseeable demand for narrowband telecommunications services, and that much if not most of the extra investment was made to anticipate future demand for video dial tone and other enhanced services. (Selwyn and Kravtin discuss this evidence in their separate

affidavit.) If so, the extra costs of the investments should not be reflected in the prices for the network elements, which would constitute a cross subsidy provided to those other services that were the impetus for the extra investment. Rather, the costs should be covered in the prices for those other services that led to the extra investment (if and when those services are actually offered).[3]

8. In any event, it is hard to see how the regulatory compact theory would apply here, for little if any of the embedded investment now on the ILECs books could have been made in reasonable reliance on the long term survival of original cost ratemaking. According to Drs. Selwyn and Kravtin, most of the ILEC rate base reflects investments made during the 1990s, when price cap regulation had largely supplanted original cost regulation for the major ILECs. Price cap regulation creates neither a ceiling on earnings nor a

---

[3] There are two possibilities. This extra investment may represent waste and inefficiency. If so, there is no legitimate competitive or regulatory basis for its recovery from prices charged for unbundled network elements. Alternatively, the extra investment may be efficient for the provision of some set of offerings that includes the regulated local exchange services, but that also includes some significant forthcoming additional services that will require expanded functionalities. If so, then the extra investment should not in any way add to the levels of the prices charged for the unbundled network elements that relate to the traditional regulated local exchange services. On the contrary, the pertinent TSLRIC is the cost of the network element that underlies the regulated local exchange service, as an *increment* relative to the expanded set of services. Because of economics of scope, this TSLRIC must be less than the cost of the network element alone, with no expanded set of services. Thus, inasmuch as the Hatfield TSLRIC of a network element, for example, is calculated without reference to and without combination with expanded services, it is a conservative estimate -- the true figure that reflects economics of scope with expanded services would be *lower*.

guarantee of recoupment.

[*5*]

III. ADOPTION OF TSLRIC PRICING SHOULD NOT AWAIT REFORM OF END-USER PRICES.

9. The ILECs argue that implementation of TSLRIC pricing of network elements is premature and should be postponed until reform of the price structure for end-user services. Until the cross-subsidies and other anomalies in the end-user rate structure are eliminated, the ILECs reason, TSLRIC pricing for network elements would result in widespread cream-skimming and arbitrage to the ILECs' detriment (but to consumers' benefit). Crandall, pp. 10-11; Harris & Yao, pp. 8-10, 23, 26-30; Hausman, pp. 2 and 4.

10. We fully agree that, without a competitively-neutral distribution and funding mechanism for the subsidized end-user services, economic pricing of network elements, like facilities-based entry, would undermine the stability of cross-subsidies and anticompetitive distortions in the existing end-use rate structure. But the 1996 Act provides a mechanism to counteract this -- the universal service fund. Its use enables the subsidy of universal service (or any other service that regulators elect to subsidize) to coexist with economic pricing of network elements.

11. Further, delay of TSLRIC pricing to preserve cross-subsidies that regulators do *not* elect to fund in a competitively neutral manner approaches the matter in a way that is completely backwards. The quickest and surest way to reform end-user rates is to open the door to the competition that would ensue from TSLRIC pricing of unbundled network elements. No cross-subsidy can long survive effective competition, which

automatically drives down the prices of overpriced services and thereby cuts off the source of financing of the nonremunerative services that are the recipients of cross subsidy.

12. In contrast, deferring TSLRIC pricing until end-user prices are fully reformed can delay pricing reform indefinitely. The 1996 Act requires freedom of competition, and assigns [*6*] the FCC responsibility for articulating principles that will promote, not impede it. If Drs. Hausman and Crandall really favor full and effective competition in the local arena, then they simply cannot proceed on the premise that distorted prices are here to stay, for that can become a self-fulfilling prophecy.

IV. ISSUES IN ESTIMATING TSLRIC

A. The Commission Should Not Limit TSLRIC Studies to Existing Network Architecture.

13. Dr. Crandall urges the Commission to forbid any use of TSLRIC studies based on network configurations and engineering assumptions that vary from existing ILEC networks, because studies based on optimal configurations, he asserts, would be too "arbitrary" and "hypothetical." Crandall ¶¶ 14-15, 20. This is unfounded. There undoubtedly will be instances when reliable evidence of a better alternative to existing network configurations and technology is lacking. But the logical response to such uncertainties is to use a best evidence standard: accept engineering assumptions that depart from existing ILEC engineering where the assumption are reliable; otherwise accept existing network engineering as the best available proxy for the optimal design.

14. Both the Hatfield model and Surface Transportation Board have adopted this approach to estimating forward-looking costs. Their experience, and the experience of states

with TSLRIC pricing, refute the notion that estimating forward-looking costs, based on engineering models of efficient network design and technology, is impractical.[4] Arbitrarily limiting TSLRIC [*7*] studies to historical network architecture and engineering would create havens for inefficiency and deprive consumers of the full benefits of competition.[5]

B. Forward-Looking Capital Costs

15. Drs. Crandall, Harris and Yao argue that the business risk by ILECs under the proposed regulatory regime will be "markedly" higher than the risk they have historically faced, and that the cost of capital included in TSLRIC must be correspondingly higher than pre-1996 capital costs. Crandall, pp. 9-10; Harris & Yao, pp. 21-22. Two responses are warranted. First, increased competitive risk is most likely to arise at the retail, not carrier-to-carrier level. Indeed, TSLRIC-

---

[4] *All* cost-based ratemaking standards (including embedded cost ratemaking) involve hypothetical constructs. As Alfred Kahn has noted, "any system of pricing involves the exercise of judgment. The question is whether that judgment should be employed in order best to apply economically efficient principles or irrational principles. . . . An approximation, even one subject to a wide margin of error, to the correct answer is better than the wrong answer worked out to seven decimal places." Kahn, *The Economics of Regulation*, vol. 1, pp. 198-99.

[5] Dr. Crandall's rhetorical contrast between "actual" (i.e., embedded) costs and "hypothetical" (i.e., prospective) costs (Crandall, pp. 8-9) has it backwards. Prospective costs *are* actual costs - - the actual costs of providing service with today's technology, prices, and know-how. Historic costs, in contrast, are *yesterday's* actual costs. Even more important, the process of *allocating* historical costs - - a crucial link in embedded cost ratemaking - - is intrinsically arbitrary. However the costs are allocated, the resulting numbers have zero economic content. In no economic sense may such costs be regarded as "actual" costs.

based prices for network elements should *reduce* the risk of inefficient competitive bypass of the ILEC's networks. Second, Selwyn and Kravtin point out that the bulk of the RBOCs' investment base has been installed since 1990, when the prospect for competitive incursions into the ILECs' markets was increasingly apparent. The ILECs' willingness to make these investments is evidence that they have regarded the current structure of returns as adequate to compensate for the competitive risks anticipated over the life of the new assets.[6]

---

[6] USTA, citing Dr. Hausman, asserts that the "reasonable profit" contemplated by the 1996 Act requires a return on investment *in excess of* an ILEC's cost of capital (USTA Comments, p. 43). USTA's position is unsupported by the cited portions of Dr. Hausman's testimony (Hausman, ¶¶ 12-13), or the views of any reputable economist known to us. "Reasonable profit," to economists, is a return on investment exactly equal to - - and not exceeding - - the firm's cost of capital. "Reasonable profit," or zero economic profit, is the return on investment permitted over the long run in competitive markets, and is the cost of capital built into TSLRIC. Contrary to USTA's assumption, competitive markets not only induce investors to "risk their capital in building new plants and facilities," but encourage optimal levels of such investment.

AFFIDAVIT OF LEE L. SELWYN AND PATRICIA D. KRAVTIN

* * *

[*2*] Findings of the ETI Study

3. In response to these arguments from the ILECs and USTA expert Hausman, we present specific empirical evidence from an ETI Study entitled *Analysis of Incumbent LEC Embedded Investment: An Empirical Perspective on the "Gap" Between Historic Costs and Forward-looking TSLRIC* ("ETI Study"), which appears as Attachment C to this affidavit. In particular, the ETI Study examines critically the notion, implicit in the arguments raised by the ILECs, that their books reflect a relatively large base of old, obsolete plant, acquired under pre-competitive conditions at a high cost relative to current prices, which the ILECs assert explains the divergence between ILEC accounting books and TSLRIC.

4. Although ETI's empirical analysis was necessarily constrained by the limited availability of ILEC data, we nevertheless find that, as a general proposition and contrary to ILEC claims and other "conventional wisdom," the existence of a "gap" between historical embedded costs and TSLRIC results *cannot* be ascribed to the obsolescence or (relative to current prices) high cost of plant put in place to satisfy basic service demand as part of any explicit or implicit pre-competition regulatory bargain imposed upon the ILECs. Rather, a primary driver of ILEC plant additions and retirements over the past few years was related to and motivated by the ILECs' pursuit of other strategic business goals and positioning for entry into new lines of business.

5. As described further below, the analyses presented in the ETI Study provide specific empirical evidence demonstrating that:

- The majority of plant carried on the ILECs' books is relatively new, having been acquired during the 1990s – a time period in which fundamental regulatory changes, competitive inroads, and corresponding strategic responses were clearly being contemplated and addressed by the ILECs:

- [*3*] In the aggregate, newer vintage plant is replacing the older vintages at the steady pace of approximately 5%-10% per year, such that the next several years, during the transition to a more competitive local exchange market environment, the ILECs will have replaced or retired virtually all categories of their pre-1990 embedded base of plant that has become economically and/or technologically obsolete;

- Of the plant acquired since January 1, 1990 that now constitutes the majority of the ILECs' net rate base, only a relatively small fraction of the gross additions in digital switching and outside plant distribution facilities can be shown to have been required to support growth in basic service demand over this period;

- A large portion of the older (i.e., pre-1990) vintage plant remaining on the ILECs' books consists of physical assets whose economic values may have actually appreciated, in that similar plant is still being acquired at reproduction costs (such as those reflected in TSLRIC studies) that in many cases are likely to be *greater* than the original (historic) acquisition cost.

6. In addition, the ETI Study also examines several case studies and other anecdotal evidence that further supports and expounds upon the conclusions of the quantitative empirical analyses. These include:

- ILEC involvement in the market for advanced Centrex-type services which, unlike POTS services, required the use of digital (as distinct from analog) central office switches, may have motivated the unnecessarily early replacement of analog central office switching plant and the massive overconstruction of outside plant;

- ILEC efforts to expand the market for additional residential lines and other discretionary services, required the ILECs to design and construct far more extensive feeder and distribution infrastructures (and expend far greater aggregate capital investments) than otherwise would have been required to provision basic local [*4*] exchange service, and appears to overwhelm simple growth in basic local exchange line demand as a principal capital investment driver; and

DECLARATION OF ALFRED E. KHAN AND TIMOTHY J. TARDIFF

* * *

II. EFFICIENT PRICING OF INPUTS MUST RECOVER MORE THAN TSLRIC-- AND TSLRIC MUST BE CORRECTLY DEFINED

4. Some parties here–notably the interexchange carriers and some competitive LECs (CLECs)–have flatly asserted that the rates for inputs provided by the LECs to other carriers should recover only "direct economic cost," which they equate to total service long-run incremental cost, or TSLRIC. These parties generally define TSLRIC as the total ongoing and future costs that would have to be incurred to provide a given service or network element using a hypothetical network that might be constructed today by a carrier starting with a completely blank slate (which we will therefore refer to as TSLRIC-BS). In view of their contention also the prices equal to TSLRIC already "include a reasonable profit," it is clear that they would permit no contribution over and above TSLRIC to be included in the rates for unbundled [*2*] network elements and terminations. In our view, that position is incorrect both on purely economic grounds and, in the present situation, in terms of good regulatory policy.

5. The failure to include contribution above TSLRIC-BS would exclude from recovery at least four other categories of costs:

a. Ongoing costs or burdens asymmetrically borne by the LECs but not their challengers by virtue of such public utility obligations as providing services--particularly basic telephone service to residential customers and particularly in rural areas--at rates below economically efficient levels, the consequent revenue deficiencies of which have heretofore been made good by contributions incorporated in prices of such services as interexchange access, toll and vertical services such as local usage and custom calling;

b. ongoing costs of the LECs to the extent their actual, prudently incurred incremental costs of providing individual services or unbundled network elements exceed those of a hypothetical network;

c. ongoing fixed and common costs, including overheads, such as, in industries characterized by widespread economies of scale and scope, efficient competitors must recover in charges above incremental costs if they are to continue in business; and

d. sunk costs, taking the form of a return on and of assets whose costs have not yet been fully recovered.

6. The ongoing costs of ubiquity. The Commission requires no reminder of the first of these cases for permitting LECs to incorporate a markup above incremental costs in their charges to competitors for use of their essential facilities. It has historically clearly recognized the underpricing of basic residential service and corresponding overpricing of such services as interexchange access and toll, which it took a substantial step to redress by imposing the subscriber line charge on end-users. And it has also recognized that so long as these rates are not fully rebalanced those distorted charges justify incorporation of a markup (such as its own [*3*] carrier common line charges) in the LECs' switched carrier access

charges--a case applicable equally to their charges for unbundled network elements.[1]

7. The parity of the cases for incorporating a contribution in the LECs' charges for the basic network elements, on the one side, and (interexchange carrier) access, on the other, is not one of logic alone; the two are inextricably linked functionally as well. If there is continued legitimacy in incorporating a markup in the latter charge--and we believe there is until the LECs' prices can be fully rebalanced to recover any necessary contribution currently provided by access charges and other rates--it becomes essential to incorporate it also in the charge for network inputs. Otherwise, the IXCs could readily bypass the FCC-legitimized carrier access charges by buying all the requisite network inputs at incremental cost, in this way bypassing the LECs' initiation and termination of interexchange calls.

8. The basic fallacy of the proposed TSLRIC-BS standard. Some commentors have insisted that the proper basis for the pricing of LEC services sold to competitors (and also for calculating any required universal service subsidies) is the TSLRIC--the total forward-looking cost of a hypothetical, ideally efficient system built by either the incumbent or some other carrier starting with a blank slate, using the most efficient current technology. In our judgment, the only correct basis is the TSLRIC of the incumbent telephone companies themselves. This is for so the following reasons:

---

[1] Presumably this deficiency in basic residential service rates could be made good by the constitution of a separately-financed universal service fund; but as the NPRM recognizes, the later statutorily-scheduled completion of the universal service reform proceeding clearly suggests, as we would strongly affirm, the legitimacy of the LEC's continuing to recover the requisite contribution in their charges for inputs during the transition period (par. 145).

a. The rationale of its proponents is that TSLRIC-BS is the level to which competition would drive prices. They are mistaken. In a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order completely to incorporate today's lowest-cost technology, as though starting from scratch: investments made today, totally embodying today's most modern technology, would instantaneously be outdated tomorrow and, in consequence, never earn a return sufficient to justify the investments [*4*] in the first place. For this reason, as Professor William J. Fellner pointed out many years ago,[2] firms even in competitive industries would systematically practice what he calls "anticipatory retardation," adopting the most modern technology only when the progressively declining real costs had fallen sufficiently below currently prevailing prices as to offer them a reasonable expectation of earning a return on those investments over their entire economic life. In consequence even perfectly competitive prices would not be set at the level of these (totally) current costs--unless, to put it another way, the calculated costs of the new plan included an extremely high rate of return and of depreciation, in reflection of the exposure of any such investments to costs and prices progressively declining in real terms over their life.

b. The Commission is not writing on a blank slate. The LECs already have a ubiquitous network serving their entire franchise territories and are constantly providing service to new customers within those territories. The economic purpose of having prices set at incremental cost is to inform buyers--and make them pay--the cost that society will actually

---

[2] William J. Fellner, "The Influence of Market Structure on Technological Progress," in Amer. Econ. Ass'n. *Readings in Industrial Organization and Public Policy* (Homewood: Richard D. Irwin, 1958), as described also in Kahn, *The Economics of Regulation*, Vol. 1, pp. 199-20, note 91.

incur or would actually save in these several circumstances: these can only be the costs of the supplier whose prices are being set.

c. The proponents of the TSLRIC-BS standard clearly imply that it will provide a cost basis for LEC charges lower than their own TSLRICs--that is, that the latter costs embody inefficiencies that would be avoided by a hypothetical totally new network. We have already cited reasons for doubting that inference: indeed, if that factual premise of the TSLRIC-BS proponents were valid, efficiency would require that the incumbent company be totally replaced, instantaneously, by a wholly new venture or scrap its entire existing plant and start over from the ground up. For this very reason, considerations of economic efficiency require that the prices charged to competitors be based upon the LECs' actual costs; to the extent competitors can provide these inputs more efficiently than the LECs, this will fully preserve their incentive to do so and thereby promote efficient facilities-based entry. In any event, it has always been their actual costs that the incumbent LECs have traditionally been entitled to [*5*] recover--if not fully in rates for underpriced services, then in the regulatorily-approved inefficiently high rates for other services, including carrier access. And where states have moved from rate base/rate of return to price cap regulation, they have typically set the initial caps and indexation formulas in such a way as to give the regulated companies a fair opportunity to recover their actual prudently incurred costs, provided they achieve the productivity goals implicit or explicit in the indexation formulas.

d. Proponents of the TSLRIC-BS standard contend that basing prices and revenue recoveries on the actual TSLRICs of the incumbent LECs imposes on consumers the costs of inefficient existing network configurations and operations. As critics of traditional cost-plus regulation, we

cannot deny the likelihood of inefficiencies under such schemes. On the other hand, assertions about their existence by critics of the LECs (1) are pure assertion; (2) ignore the fact that in the majority of states the LECs are now subject to price cap regulation--and have been for some five years in the federal jurisdiction--which has given them strong incentives to improve their efficiency; and (3) in any event, if, in departure from past regulatory practice, costs are to be disallowed on grounds of inefficiency, it surely would be up to the state regulators to do so.

e. Finally, it is prices based on the actual incremental costs of the incumbent LEC that are the proper target for comparison by rivals contemplating entering the market. If, as its proponents seem to assume, the TSLRIC-BS were lower than the TSLRIC of the incumbent LEC, basing the LEC's charge for network elements--below its own costs--on the former measure would offer rivals a smaller reward for deploying their own facilities than the superiority of their costs would justify. If, instead, the TSLRIC of the incumbent LEC were lower than TSLRIC-BS (correctly measured, as we have explained, to take into account future obsolescence), then LEC charges based on the latter measure would overcompensate entrants--that is to say, would encourage entry of firms imposing incremental costs on society greater than are imposed by the incumbent suppliers.

9. The recovery of joint, common and overhead costs. The Commission explicitly recognizes the third possible justification we have listed for incorporating a markup in these several charges for unbundled elements and call terminations--the fact that in industries characterized by ubiquitous economies of scope and scale, giving rise to costs common to or [*6*] shared by a variety of services or products, prices for each of them set at bare incremental cost will in the aggregate fail to

recover total costs, even when the latter are defined in purely economic (ongoing and future) terms (par. 129).

10. AT&T purports to refute this case for a markup above incremental cost by asserting that such network elements as loops, switching, transport and signaling are discrete physical elements of local networks, which, if costed separately, would leave "few if any shared facilities costs" that would not be recovered in their TSLRIC prices. That is to say, without denying that charges for such end services as toll or local calling at bare incremental costs would fail to recover such costs common to those two services as switching and transport–the sharing of which among such services is the primary source of economies of scope–AT&T is saying that there are virtually no such costs shared by the several network elements that LECs would be required under the new law to offer and therefore no problem of charges at bare TSLRIC failing to recover them. We are not in a position to appraise that factual contention; but we point out that even if it is correct, it fails to respond to the (a) undeniable presence of economies of scope among the LECs' own retail services; (b) the necessity of their recovering those costs–confining our attention to strict economic costs–via varying markups above incremental costs in their charges for those services–just as AT&T does itself[3] and (c) the certainty that if competitors such

[3] AT&T uses its network to produce and sell services to high- and low-volume users of long-distance service. The latter pay rates several times incremental cost; large users pay rates much closer to incremental cost. AT&T recovers the costs shared across these services (low and high volume customers) on the basis of what the respective markets will bear. This example directly contradicts the assertion of Professors Baumol, Ordover and Willig that "prices in competitive markets converge to incremental cost" (par. 12). While this statement describes hypothetically *perfectly* competitive markets, it certainly does not describe telecommunications. For (continued...)

as AT&T were free to acquire network elements at bare incremental costs, they could confidently be expected to use those loops to compete away LEC sales of the high-margin services and so undermine the rate structure that enables the incumbent companies to recover their total costs, as we observe more fully at pars. 7 and 19.

11. There is another way in which a requirement that LECs sell unbundled network elements to their competitors could distort competition–this time competition with facilities-[*7*]based third party rivals. There will inevitably be a great deal of cost averaging in measures of TSLRIC for individual network elements: loops as a group presumably share the costs of poles, trenching, loop testing equipment and excess loop capacity to allow for growth (such as the growth in demand that might result from entry of competitors using unbundled loops). Presumably those shared costs could be fully recovered by charges equal to average TSLRIC–that is to say, by charges embodying a proportionale share of those shared costs. If then an LEC were required to sell those elements to AT&T–let us say–at that average TSLRIC and were in addition subjected to an imputation rule, requiring it to impute that average to its own retail services, in order to ensure competitive parity, it could then be undercut by a facilities-based competitor that, for competitive reasons, chose to charge retail prices that recovered a lower-than-average markup on sales in particular markets. This is by no means a remote possibility: AT&T of course obtains lower markups on toll service to high-volume than to low-volume users. Yet an incumbent LEC would be precluded from meeting the competition for such customers from CLECs, who would not be bound by the cost-averaging rule implicit in

[3] (...continued)
example, when AT&T's incremental cost (including access charges) was about $0.07 per minute, its average revenue per minute was about $0.18.

AT&T's demanded TSLRIC pricing of network elements. The mixing together of average cost pricing in the mandated charge by LECs to some competitors for unbundled network elements and market-based pricing such as is routinely practiced by facilities-based competitors would thus be another source of distortion.

12. The recovery of sunk costs. The NPRM explicitly recognizes also the possible legitimacy of a markup contribution to the recovery of the sunk costs of incumbent LECs–item (d) on our list above–in par. 144. The answers to the questions it raises there, we suggest, are best supplied by the state regulatory commissions. It is they that have determined the revenue entitlements of the several LEC's under their jurisdiction, in conjunction with the FCC, prescribed the depreciation policies that have determined the residual amount of embedded costs legitimately recoverable and specified the mechanisms for their recovery–whether, as has been the historical practice, in cost-of-service, rate base/rate of return proceedings or, more recently, in determining the structure of "just and reasonable rates" serving as the beginning point for price caps, rate freezes, indexations and other kinds of incentive regulation. And it is their responsibility to ensure that the markups above incremental costs that they allow are no more than sufficient to recover these costs that constitutes the full [*8*] response to the demagogic contention by Professors Baumol, Ordover and Willig that such markups would "lock in the ILECs' monopoly profits..." (par. 23).

13. It would be difficult to measure the costs (in the form of the disincentive it creates for the LECs to invest further in their networks and the higher costs of capital in the future if investors are to make their funds available) of any such denial by government regulators of the entitlement of investors to recovery of costs prudently incurred and recoverable under previously prevailing regulatory policies. These costs are real,

however, and cannot be ignored. Entirely apart from the inescapable question of equity that such denials would raise, it is a reasonable economic (as well, perhaps, as constitutional) question whether a market system can survive if governments feel free opportunistically to change the rules of the regulatory game at the expense of investors, when it is temporarily to the advantage of consumers to do so. Indeed, AT&T's lead witness here has suggested that regulated companies must be allowed to recover their historical costs during the transition to competition for these very reasons.[4]

14. It would indeed be preferable on grounds of pure economic efficiency if these several justified costs were made good not by markups in the charges for inputs but in the prices of final products or services only. The reason is that markups

---

[4] On page 10 Baumol, Ordover and Willig state: "Book costs are unlikely to reflect economic costs accurately, and basing the prices of network elements on book cost would be dangerously counterproductive." (See their many other such statements e.g., in pars. 5, 7 and 8).

To the extent that book costs exceed forward-looking costs, the difference between the two measures would be "stranded." Unless these witnesses have in mind some vehicle for recovery of historical costs other than the prices of inputs sold to competitors, their position here is starkly inconsistent with the position that Professor Baumol has taken in the electric industry. For example, in association with Professors Joskow and Kahn, he has asserted forthrightly: "A failure now of policy makers to ensure the companies at least some reasonable level of recovery of their regulatorily approved costs in any transition to competition would leave investors, in effect, with part ...of the value of their property expropriated by the change in the rules of the game. "The Challenge for Federal and State Regulators: Transition from Regulation to Competition in Electric Power," December 9, 1994, p. 34. Similarly, in collaboration with Sidak, he said: "Failure to allow recoupment of stranded costs will clearly violate this implicit regulatory compact. And aside from inequity, the failure to recoup could also deter capital investment" "Stranded Cost Recovery: Fair and Reasonable," *Public Utilities Fortnightly*, May 15, 1995, p. 22.

above incremental cost in the prices of inputs introduce the possibility of productive inefficiencies: so long as the demand for these inputs is not totally inelastic, the markups will result in some inefficient substitution of other inputs (with higher incremental costs) for the marked-up ones.

[*9*] 15. So long, however, as governments or regulatory agencies (1) feel bound, as we believe they should, to respect their commitments to afford public utility companies a reasonable opportunity to recover their legitimately-incurred costs, past and ongoing, and (2) are unwilling to do so by rebalancing final product or service prices, markups on inputs may be the best method available - at least during the interval (as brief as possible) over which high book values are written down and either rates are rebalanced or alternative methods of universal service funding installed.

16. The meaning of "a reasonable profit." We interpret the provision of the Telecommunications Act that charges for network elements must be based on cost by may include a "reasonable profit" as, at the very least, consistent with the foregoing statements of economic and regulatory principle, if not explicitly enduring them. Some parties have argued, on the contrary, that the statutory standard is satisfied where the prices of inputs provided to other carriers are priced at bare TSLRIC on the ground and economic cost already includes a "reasonable profit."

17. Entirely apart from the justifications we have already provided for the recovery of contribution there are the following responses to these assertions:

e. The Act says that these charges must be "based on costs." This clearly does not mean that they must be equated to cost.

b. In strict economic terms, the requisite return on incremental investments that is indeed included in measures of LRIC is a cost–the cost of capital–emphatically not a

"profit."[5] In strict economic logic, therefore, the permissibility of incorporating a "reasonable profit" contemplates charges above pure LRIC or TSLRIC.

[*10*]c. "Profit" has no economic meaning as applied to the price or revenues from any single service–or network element–supplied in common with other services. It has economic meaning only as the difference between total revenues and total costs (including in the latter the cost of capital) for an entire firm or accounting entity.

d. In the presence of economies of scope and scale, the sum total of revenues flowing from prices uniformly set at TSLRIC will–as the NPRM explicitly recognizes (par. 129) and as we have already pointed out–fall short of total economic costs. This is precisely why second-best pricing, with markups above TSLRIC are required.

e. The costs of regulatorily-prescribed underpricing of basic residential service would clearly have to be recovered if the LEC were to show a profit in purely economic terms; if the prices of some of its services are prevented by regulation from recovering their incremental cost,

---

[5] A typical statement of this elementary proposition is, from Professor Paul A. Samuelson's standard and celebrated text:

> We have already encountered...examples of true economic costs that do not show up in business accounts. The return to an owner's effort, the normal return on contributed capital to a firm, a risk premium on highly leveraged owner's equity–these are all elements that should figure into a broadly conceived set of economic costs but do not enter business accounts. An economist would insist that the wages of management or the return on contributed capital are real economic costs. They use real, live managers and tangible capital. Samuelson and Nordhaus, *Economics*, Twelfth edition, New York; McGraw-Hill, 1985, p. 469.

firms will not earn a profit if all other charges are at incremental cost.

b. Finally, if the "reasonable profit" that the Act permits is intended to be understood in traditional accounting terms, rates would have to recover book as well as purely economic costs. These are, after all, the costs that the carrier actually has incurred in order to provide service.

18. The relationship between charges for unbundled inputs and the present rate structure. We have already cited the fact that the present rate structures of the LECs embody long-standing regulatory policies of deliberately pricing some services markedly above incremental costs in order to hold the prices of other services either at or below those costs and the FCC's acknowledgment of the consequent constraint on it to permit the LECs to incorporate a carrier common line charge and other public policy rate elements in their access charges to long-distance carriers. It has of course not been mere coincidence that the former services–incorporating these public policy add-ons– are the very ones that have become subject to increasing competition.

19. In these circumstances, the NPRM's "tentative conclusion that carriers can request unbundled elements for purposes of originating and terminating interexchange toll traffic" (par.163) could not be intended to give them the right to obtain those elements at bare cost unless the Commission were intending now to abandon the existing access charge regime. If the long-distance carriers were now free to purchase and assemble all the network elements necessary to [*11*] originate and terminated their calls at incremental cost, they could and would circumvent those charges and undermine the present balance between over- and under-priced retail services, by reducing the market prices of the former.

20. The NPRM poses the same question in another way (par. 85); Do the unbundling requirements in effect provide entrants with an alternative way to "resell" the various retail services of the incumbent LECs, apart from the specific statutory rules for resales? If a competitor could order and combine network elements at bare incremental cost in such a way as to offer the same or similar retail services as it is entitled to purchase under the resale provision, there would be no point to the resale provision as it might apply to retail services (such as toll) that are compensatory or supercompensatory.

21. Other things equal, such a charge for inputs would conduce to economic efficiency, for reasons we have already expounded. But until the pertinent rates are full rebalanced or some alternative method devised for supplementing revenues from the underpriced services, the recommendation of the IXCs here with the respect to pricing of unbundled inputs would undermine long-established regulatory policies, including FCC's own carefully balanced interexchange carrier access charges.

III. RECOVERY OF THESE COSTS WOULD NOT PRECLUDE EFFICIENT COMPETITION

22. The final argument of the parties who insist that the rates for unbundled network elements or other inputs provided to competitors must be set at TSLRIC is that any rates in excess of that level would impede competition. What these parties fail to recognize is that the incorporation of markups in the charges for inputs has in itself only an indirect bearing on whether efficient competitors are able to challenge the incumbent firms.[6]

23. The rules of competitive parity. The relationship

---

[6] We explain this indirect effect at note 8, below.

between the charges for inputs and the opportunities for efficient competitive entry–it is essential to understand–has two vital aspects. One–which is totally ignored by the comments–is that in the present circumstances in the telephone business, markups in the charges for essential LEC network services are [*12*] necessary in order to ensure that competition is efficient. So long as the present regulatorily-imposed rate structures of the LECs, reflecting the historical practices of pricing basic residential service residually and averaging costs geographically, necessarily embody charges for some services above incremental costs, there is absolutely no assurance that the competition that the latter rates have attracted–and continue to attract–is efficient. Those rates indisputably create an opportunity for entry by rivals less efficient–that is, the incremental costs higher–than the incumbents. We see not recognition in the comments of the necessity for markups to equalize the competition that would otherwise be to the disadvantage of the incumbent LECs.[7]

24. The other side of the coin, assertedly, is of course the one emphasized by the proponents of setting rates at incremental cost–that if rates are too high, efficient competitive entry may be deterred. This second view, we respectfully suggest, reflects a failure to comprehend the simple but absolutely fundamental fact that the critical determinant of the opportunity for competitive entry is not the level of the charge

[7] To be sure, that competition could be equalized also–and inefficient entry discouraged–by the incumbent companies reducing those subsidizing rates down to incremental costs. But that would involve a renunciation on their part of their historical entitlement to recovery of those unique costs and a violation of their obligations to their own shareholders. The more likely consequence of giving them freedom to reduce those rates wold be that they would set them at levels holding an artificial umbrella over less efficient competitors, so long as it appeared that the benefits to their shareholders of retaining the margins outweighed the consequent losses in market share.

entrants pay incumbents for an essential input but the margin between it and the prices of the competitive services.[8] Consequently, a pricing method that permits markups in the charges for network elements or other inputs could not in itself constitute a barrier to efficient entry.

25. Essential to the conception of an entry barrier is that it confer on incumbents a competitive advantage over would-be rivals. As Professor George J. Stigler put it:

> [*13*] a barrier to entry may be defined as a cost of producing...which must be borne by a firm which seeks to entry an industry but is not borne by firms already in the industry.[9]

The markups above incremental cost in the charges to competitors for network elements would confer no such advantage. Far from imposing a cost on would-be rivals that would not be borne by the incumbents, permitting the latter to recover embedded and ongoing costs associated with their

[8] The level of the charges does, because of the elasticity of demand for the final products, determine the size of the total market and therefore the number of minimally efficient competitors that it will support. This is one reason why that absolute level is by no means a matter of indifference; and it argues, specifically, that the level be subject to regulatory determination that such markups as they contain are no more than necessary to fulfill regulatory obligations to the incumbent companies and to guard against inefficient entry that would otherwise be attracted by the inflated prices of the end services. Transferring the burden of recovery of these contributions from those end service prices to the charges to competitors for essential inputs in no way constricts the market additionally, however.

[9] The Organization of Industry (Homewood: Richard D. Irwin, 1968, p. 67. See the fuller discussion in W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust*, 2d ed., Cambridge: The MIT Press, 1995, p. 159; see also pp. 158-62

unique service obligations would restore a balance in a situation in which it is the incumbents that have incurred and/or continue to incur costs that are not borne by their challengers.

26. In the most famous case involving as asserted use of market power in the supply of an essential input to deny rivals a fair opportunity to compete, the antitrust suit under Section 2 of the Sherman Act against the Aluminum Company of America, the condemnation of Alcoa for exclusionary practices directed against competing fabricators depended not to the slightest extent on the level of its charge for the ingot that they had to purchase from it. It was based, instead, on the courts' finding that the margin between Alcoa's charges for ingot and for fabricated products–within which competing fabricators had to survive–was narrower than Alcoa's own incremental costs for fabrication. The rules of competitive parity explicitly preclude that possibility. By requiring–other circumstances being equal–that the prices charged for the competitive services by incumbent LECs be high enough to recover both the charges for basic network elements that their rivals pay and their own incremental costs, they ensure that competitors with incremental costs equal to or lower than those of the incumbent will indeed be able to enter and survive.

27. The inapplicability of competitive parity rules to non-compensatory services. As the NPRM clearly recognizes, application of such a competitive parity rule to the relationship between (wholesale) charges for unbundled inputs and the retail prices of services that are priced below cost is unnecessary to permit efficient competition. This is so because the [*14*] unbundled inputs give competitors and LECs alike access to the retail market not just for the underpriced services, but also for the

> relatively overpriced revenues for toll service, interstate access, vertical features, and other offerings to make up for the underpricing of basic residential local exchange services. (par.16)

It correctly recognizes also the additional objections to application of an imputation rule in these circumstances–which would "require[s] that unbundled elements be priced below cost"–namely (1) that (unless and until some competitively-neutral method were installed for providing the subsidies) the competitors would in those circumstances be enabled to undermine the regulatorily-prescribed rate structure making possible the underpricing of the politically sensitive services, and (2) "if unbundled elements were priced at less than cost, then efficient facility-based entry would be deterred...."(par. 186)

28. The rule governing sales for resale and efficient competition. We strongly endorse the Act's resale provisions; by enacting the principles of competitive parity, [10] they invite efficient competition in the retailing of the particular services resold, with the outcome determined by comparative efficiency in performing the retailing functions. Where the resold services are priced non-compensatorily, however, these requirements pose the same threat of undermining regulatorily-prescribed rate structures and discouraging facilities-based competitive entry as would a requirement that the relationship between the prices of unbundled network elements and those retail prices satisfy the imputation or competitive parity tests. For this reason, as the

---

[10] Those principles require that the incumbent's retail price for the competitive services (these would be the prices for fabricated aluminum products in the Alcoa situation) must be no lower than the wholesale charge for the essential input (read: aluminum input) plus its incremental costs of performing the retail function (read: Alcoa's fabricating costs). The resale rule says that the wholesale price of the competitive service must be no higher than the retail price minus the avoided costs of retailing, i.e., Alcoa's fabricating costs). These two requirements are identical.

NPRM recognizes, the statue permits state commissions, subject to FCC regulations, to place restrictions on resales of such services to categories of customers not eligible for the subsidized retail rates. Unless and until the relevant rates are rebalanced, therefore, respectively down closer to and up to compensatory levels, or competitively-neutral sources of funding developed to subsidize rates that continue to be held down incremental costs plus and efficient markup, [*15*] such restrictions on resale make good economic sense and, for the reasons the Commission itself supplies, deserve to be incorporated in any rules adopted at the Federal level.

29. So far as services whose retail prices are compensatory are concerned, manifestly no such restrictions on the markets in which they may be resold are either necessary or desirable. On the other hand, precisely because these services will be selling at both retail and therefore also at wholesale at prices in excess of incremental costs, the resale provisions of the Act provide further refutation of the demand by the interexchange carriers that the capabilities for providing various retail services be provided to them in the form of unbundled network elements priced at bare incremental cost. As we have already pointed out, if that demand were to prevail, it would make the resale provisions of the Act irrelevant. Would-be challengers would always find it to their interest to purchase and assemble all the necessary inputs themselves, at incremental costs, rather than avail themselves of the more costly resale option that provides contribution to help cover the LECs' total costs. From the standpoint of ensuring both efficient competition and regulatory consistency, the correct prescription would be to require the IXCs to purchase these retail services under the pricing standard in the resale provision.

REPLY COMMENTS OF COX COMMUNICATIONS, INC.

* * *

[*27*] Finally, the Cox model, which uses TSLRIC only as a boundary, does not inflexibly constrain LECs from making a case that they should recover amounts over and above TSLRIC. Where an incumbent can show that TSLRIC would not be sufficient, it will have the opportunity to pursuade a State commission that prices for unbundled elements should be calculated using FDC.[78] This will permit each State to make its own determination as to the appropriate level of incumbent cost recovery for unbundled elements.

2. There Is No Reason to Permit LECs to Recover More than the Fully Distributed Cost of Unbundled Elements.

Some ILECs suggest that the Commission should adopt a standard for pricing unbundled elements that permits them to recover their embedded costs plus some additional amount, either as "profit" under Section 252(d)(1) or on the basis of foregone monopoly revenues in the future.[79] There is no rationale to permit such an approach.

First, it is important to recognize that, as an absolute cost ceiling, FDC more than compensates a LEC for any cost it

---

[78] While States should have the latitude to determine that some or all costs for unbundled elements should be based on recovery of embedded costs, Cox envisions that FDC would be the exception, rather than the generally applied standard.

[79] See, e.g., Comments of BellSouth at 56-57; Comments of Cincinnati Bell at 30-31; Comments of USTA at 47.

reasonably could expect to recover. FDC is based on embedded costs, *i.e.*, the costs the LEC has incurred, and includes profits calculated using embedded costs. Incumbent LECs have no legal entitlement to more than that.[80] Moreover, [*28*] as shown above, many incumbent LECs already have informed shareholders that they do not expect to recover all of their embedded costs by writing down the financial book value of their telephony assets.[81]

---

[80] Indeed, any price that exceeds fully distributed cost is likely to be too high and, consequently, legally impermissible because it exceeds the bounds of the zone of reasonableness. See Washington Gas Light v. Baker, 188 F. 2d 11, 15.

[81] See supra page 25. In addition, BellSouth suggests that embedded cost and book cost are, in fact, the same. Comments of BellSouth at 56. To the extent that this is true, the written-down values of telephony assets on the companys' financial books would be the correct ones to use to determine embedded cost, not the values on the LECs' regulatory books.

REPLY COMMENTS OF THE NATIONAL TELECOMMUNICATIONS AND INFORMATION ADMINISTRATION

* * *

[*14*] expanding the number of actors in determining such obligations, NTIA's proposal ensures that the process will be dynamic and not unduly affected by the decisions of a single entity. Although NTIA's approach will not eliminate local or, perhaps, regional variation in the interconnection/ unbundling requirements prescribed, it will create a trajectory of increasing interconnection and unbundling obligations, with all of the competitive benefits that such a path is likely to generate.

III. PRICING OF INTERCONNECTION AND UNBUNDLED NETWORK ELEMENTS

If Section 251's interconnection and unbundling provisions are designed to promote competition, the pricing of network interconnection and unbundled network elements will determine to a large extent how effective Section 251 will be in achieving that objective. Generally speaking, the Act requires that the rates established for interconnection or for network elements should be: (1) nondiscriminatory and (2) based on the costs of providing such interconnection or element, including a reasonable profit.[30] The Notice seeks comment on how best to ensure compliance with that standard.

---

[30] Act § 252(d)(1). The Act's specification that rates may provide a reasonable profit is somewhat redundant because conventional economic measures of "cost" assume a reasonable or "normal" profit.

[*15*] NTIA agrees with the Commission and the Department of Justice that the Commission should establish a minimum set of principles governing the pricing of interconnection and unbundled network elements.[31] As the Commission points out, Section 251(d) of the Act requires the Commission to adopt regulations to implement the statutory requirements for ILECs to provide interconnection and unbundling on "just, reasonable, and nondiscriminatory" terms.[32] Nationwide pricing principles would furnish a certain and consistent benchmark for assessing ILEC's compliance with that fundamental obligation.

Commission-prescribed pricing principles would also serve the Act's overriding pro-competitive goals in the same way as a national framework with respect to interconnection and unbundling. They, would, for example, increase the predictability of interconnection and unbundling pricing, making it easier for new entrants to develop their business plans and facilitating negotiation, arbitration, and review of interconnection agreements between entrants and ILECs.[33] At the same time, national pricing principles would not encroach upon the rights of State commissions because they would retain responsibility for applying those principles (in contested negotiations) to [*16*]establish or to approve specific prices in particular circumstances.[34]

---

[31] Notice ¶¶ 39-40; DOJ Comments at 24-26.

[32] Notice ¶ 117 (citing Act §§ 251(c)(2), (c)(3)).

[33] DOJ Comments at 25; Notice ¶ 40.

[34] DOJ Comments at 25.

We should emphasize here that any pricing principles adopted by the Commission should give negotiating parties every opportunity to reach mutually acceptable agreements with respect to price as well as other network interconnection and unbundling details. In the event that negotiating parties fail to reach agreement, the State regulator should establish the appropriate price for the interconnection to be provided, based on specific Commission-prescribed guidelines that embody the pricing objectives described below.

A. General Pricing Principles

In establishing national principles for pricing interconnection arrangements and unbundled network elements, the Commission's central objective should be that identified by Congress -- to ensure that the rates for those offerings reflect underlying costs. Regulations that govern telecommunications service pricing should be designed to produce service prices equal to the opportunity costs society incurs from having its scarce resources devoted to the production of these services.[35] [*17*] Policies that deviate from this basic principle will send incorrect price signals and thereby distort ILEC and new

---

[35] Prices should be based upon "forward looking" costs – the expenditures that a business will incur or avoid as a result of future decisions. "Economically efficient pricing looks not to the past – not to how we got where we are – but to the future; efficiency requires that prices tell customers what incremental resources society will use if they take more of the good or service in question, what resources society will save if they consume less of it." Alfred Kahn and William Shew, Current Issues in Telecommunications Regulation: Pricing, 4 Yale J. on Reg. 191, 224 (1987) (Kahn and Shew).

entrants' investment decisions, as well as consumer purchases, in a manner that harms society's economic welfare.[36]

On the one hand, requiring ILECs to establish prices that are below the true costs of providing their services will likely encourage excessive entry by resellers in the short run, thereby expanding service consumption beyond the economically efficient point. Below-cost pricing also may not allow ILECs to make economically efficient investments in telecommunications infrastructure. On the other hand, allowing ILECs to price services above costs will retard entry by resellers, depress service consumption relative to the economic optimum, and invite economically inefficient facilities-based competitive entry.

Establishing a set of economically efficient prices is complicated by at least two factors. First, provision of telecommunications services appears to be characterized by [*18*] significant joint and common costs.[37] There is no easy way to apportion such "shared" costs among the services involved so as to establish the "true" costs of providing each service. Second, setting efficient prices requires considerable information on underlying costs that are typically within control of the serving ILEC, rather than the relevant regulator. The ILEC obviously has no strong incentive to reveal private cost information that may do it harm.

---

[36] The extent of this "allocative" distortion depends upon the level of usage and investment either stimulated or stifled by inefficient pricing.

[37] See, e.g., Kahn and Shew, supra note 35, at 194. Joint costs are expenditures that are incremental to a group of services, but not to any particular service within that group. Common costs are expenditures that, at least in theory, can be attributable to a particular service.

B. TSLRIC: An Analysis

Given the asymmetry in cost information between regulators and regulated firms, the Commission should not sanction any costing methodology that relies heavily on ILEC-provided information. A number of commenters in this proceeding have proposed an alternative approach, referred to as total service long run incremental cost (TSLRIC). Because TSLRIC cost estimates are not based on ILEC-provided information, NTIA believes that they can be very useful to the Commission and State regulators in securing efficient and pro-competitive prices for interconnection and unbundled network elements. As discussed below, TSLRIC can be particularly valuable if employed as a lower bound with which to structure negotiations.

[*19*] In their most basic form, however, TSLRIC estimates alone may not be sufficient to accomplish the regulator's pricing objective -- fostering competition through interconnection rates that accurately reflect input costs.[38] For instance, as NARUC correctly notes, "because some shared costs are not included in the calculations of TSLRIC, a firm that collects only TSLRIC from all of its services will not be able to cover its total costs, including overheads, and could not remain

---

[38] Cf. DOJ Comments at 30 ("If the prices that competing carriers pay for their inputs are distorted from the true economic costs of those inputs, those prices will lead carriers to choose technologies that will minimize their use of overpriced but lower cost inputs, thus impairing the quality or increasing the cost of their service offering"). This implies that if prices are below the "true economic costs" of inputs, carriers will choose technologies that maximize their use of underpriced but higher cost inputs.

viable over the long term."[39],[40]

---

[39] See id. at 35. Hatfield's TSLRIC model does attempt to account for some administrative overhead:

> Certain costs that vary with the size of the firm, and therefore do not meet the economist's definition of overhead, are often included under the classification of General and Administrative expenses. For example, if a LEC did not provide loops, it would be a much smaller company, and would therefore have lower costs. Some of those costs are attributed to overhead under current LEC accounting procedures. We therefore include a portion of these "overhead" costs in our TSLRIC estimates.
>
> Historical overhead expenses for the LECs, such as administration, planning, legal, and human resources seem excessive when compared to firms that operate in a competitive environment. The relationship between revenues and overhead for selected firms in the auto manufacturing and airline industries was examined. A six percent overhead loading factor was found for these industries. The cost of the functions that this factor is used to estimate should not vary widely across industries. In other words, the relationship between revenues and administration, plaining, legal, and human resources are likely to be similar in the telecommunications industry.

Hatfield Associates, Inc., The Cost of Basic Network Elements: Theory, Modeling and Policy Implications 30 (March 1996) (prepared for MCI Telecommunications Corp.)

We note that by defining shared costs as not being incremental to any one service, we do not imply that these costs are invariant to the size of the firm, as Hatfield contends. It is also unclear how sensitive Hatfield's TSLRIC estimates are to changes in the six percent overhead factor. To the extent that Hatfield excludes some shared costs or its six percent factor underestimates true overhead costs in telecommunications, its TSLRIC model may underestimate the ILECs' costs.

---

[40] Economists generally agree with NARUC's assessment that TSLRIC prices do not cover all of the ILECs' joint and common costs. For example, Harris and Yao note that

> In addition to TSLRIC, LECs also have shared costs which are incurred for facilities and resources used in the production of two or more services, and can therefore not be eliminated by the discontinuation of a single service. Examples of shared costs include fiber strands used for transport services, and stand-by modular switching capacity. These shared costs are incurred whenever LECs provide services to end-users and should therefore be reflected in retail, wholesale, unbundled network element and call termination prices. Some portion of common costs also need to be recovered. Common costs are incurred through facilities and resources used in the production of all the LECs services.

Robert Harris and Dennis Yao, Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange 18 (May 1996) (Attached to Comments of US West, Inc.) (Harris and Yao). Harris and Yao used the term shared costs in the way that we (and NARUC) use the term joint costs. We use the term shared cost to refer to both joint and common costs.

Potential interconnectors acknowledge that joint and common costs are part of the long-run incremental costs of a service that should be recovered. They are legitimately concerned nevertheless, about an IEC's' incentives to overstate those costs. As AT&T puts it:

> the TSLRIC of a network element includes all of the element-specific investment needed to construct and operate the facilities used to produce that element, including costs that are fixed in the short run. There may well be some cases of non-trivial "common" or "shared" costs, however, and, particularly in light of the potential for confusion and abuse in this area, it is critical that the Commission establish rules to constrain the ILECs' incentives and abilities to manipulate the quantification and allocation of "common" or "shared" costs in ways that thwart competition.

(continued...)

[*20*]

[*21*] Further, estimation of TSLRIC requires the identification of a cost-minimizing service output level. This, of course, requires a prediction regarding the service's peak load (or busy-hour) demand. TSLRIC assumes no change in the size of the service's peak load demand. That assumption can be criticized in several respects. Today's demand figures result from a pricing structure that should change with the arrival of competition. More importantly, current demand is based on service prices that may be substantially higher than service prices under TSLRIC. Unless demand for network elements is perfectly inelastic, any lower prices will stimulate, perhaps substantially, service demand.[41] Using TSLRIC estimates alone may therefore [*22*] underestimate the ILEC's true cost of creating and maintaining a network of sufficient size.[42]

---

[40] (...continued)
Comments of AT&T Corp. at 62-63 (emphasis in original) (footnotes and citations omitted). NTIA strongly agrees that only those costs that are truly incremental to the provision of a service or functionality should be considered in reviewing interconnection rates.

[41] The existence of economies of scale and peak-load demand problems in the telecommunications sector suggests that identifying economically efficient prices requires not only cost studies, but analyses of service demand as well. Because TSLRIC largely ignores the service demand dimension, the use of TSLRIC alone will be limited in its ability to yield an economically efficient set of prices.

[42] A second drawback of TSLRIC is that it is based on the cost of providing an entire service, as opposed to traditional economic cost measures that identify the cost of providing additional units of a service (e.g., LRIC). In practice, however, it may not be possible to measure accurately changes in average costs associated with changes in output. As

(continued...)

Assuming one could overcome these difficulties, relying solely on TSLRIC-based prices may be unwise for several reasons. Although interexchange carriers (IXCs) have argued that a forward-looking, least cost methodology reflects the "true" economic cost of providing service. TSLRIC estimates differ from standard economic long run costs. Typically, a firm's costs reflect not the plant it could conceivably create, but rather the plant it already has. The theory of long run adjustment in a competitive market holds that, if the provider's plant does not permit the most efficient means of production, potential entrants have an incentive to construct the appropriate plant, implement the least cost production process, and undersell the incumbent. [*23*] In the long run, only those firms that use the least cost technology will remain in business.[43]

---

[42] (...continued)
a result, the best available "increment" for deriving incremental costs will likely be the entire service or functionality. Indeed, the cost principles we advocate below employ a service or functionality as the increment.

[43] In this respect, TSLRIC runs up against the theory of long-run adjustment in a competitive market:

> Even when they do not have any shared and common costs, firms in competitive industries experiencing rapid technological change do not price their goods and services at TSLRIC. Under standard economic theory, the least efficient, viable producer in an industry would earn zero economic profits. All producers using older technology are, at least in the short-run, forced to either upgrade their plant or exit the market. Conversely, positive economic profits are earned by the most efficient and innovative firms in a competitive market. Therefore, what often occurs in competitive industries is that a production facility makes above average profits during its early years of operation which decline over time until the firm is forced to upgrade or close down the production facility.

(continued...)

Further, to the extent that these rates reflect a low cost network that is yet to be created, incumbents may have to accept interconnection payments below their actual costs of supplying service. Also, if interconnectors receive rates associated with the least cost method of production, none will have the incentive to create its own efficient network. Finally, no service provider [4] would have an incentive to operate the existing network if constrained to provide interconnection at TSLRIC-based rates that are below average cost.

[*24*] One important potential advantage of the TSLRIC approach, however, is its relative ease of calculation. Rather than estimate costs reflecting the present ILEC network -- a difficult task even if ILECs provided reliable data -- it is possible to generate TSLRIC estimates based on a "green field" approach, which assumes construction of a network from scratch. A recent TSLRIC model created by Hatfield Associates (Hatfield),[44] for example, estimates the least cost method of providing a service to a given number of customers with the best available technology. To its credit, Hatfield's methodology employs a forward-looking cost approach. But, a TSLRIC model based solely on "green field-derived" costs may not measure forward-looking costs sufficiently from the perspective of either the ILEC or the regulator. The ILEC's

---

[43] (...continued)
However, if industry-wide prices were set at TSLRIC, only the most efficient producer using the latest technology would be able to cover its costs and make a profit.

Harris and Yao, supra note 40, at 19.

[44] Hatfield Associates, Inc., The Cost of Basic Network Elements: Theory, Modeling and Practice (Mar. 1996) (prepared on behalf of MCI Telecommunications Corp.).

forward-looking costs are reflected in its short run marginal cost curves -- not the cost point estimate generated by Hatfields green field methodology.[45]

[*25*] Despite the limitations of a TSLRIC approach, it nevertheless offers an objective, tractable means of estimating the costs of an ILEC's services and functionalities. For that reason, NTIA believes that TSLRIC should be part of the pricing principles that the Commission adopts to ensure just and reasonable rates for ILEC interconnection arrangements and unbundled network elements.

---

[45] We understand that the Hatfield model has been revised to address concerns about its green field nature. Specifically, it appears that the approach has evolved from a "scorched earth approach [that assumes] no direct interoffice trunking and homogenous population density zones" to a "scorched node approach using outputs from the Benchmark Cost Model [developed cooperatively by IXCs and ILECs] to size loop plant requirements." Comments of AT&T Corp., App. E at 1 n.1. Because we believe that TSLRIC estimates should be based on actual ILEC costs, we support, as a general matter, any attempt to modify the Hatfield model or any other TSLRIC model in that direction.

C. TSLRIC as Part of a Banded Approach

The optimum costing methodology would allow the Commission and State commissions to set interconnection rates at the long run average incremental cost (LRAIC) of service for the present network.[46] In this way, incumbents would recover

---

[46] As the Department of Justice notes:

> The TSLRIC methodology would price network elements at the long-run, forward-looking economic costs of the particular network element, given the efficient provision of all other network components by the ILEC. This standard would be "forward-looking" in that it would be based on the best generally available technology, current input prices, and economic cost-minimization. It would be "long run" in that it would include the forward looking capital costs necessary to provide the element. It would define and utilize the network element as the appropriate "increment," and its added cost would be the added economic cost of the element conditioned on the provision of other network components.

DOJ Comments at 27. NTIA's LRAIC also uses the network element as the appropriate increment, although NTIA recognizes that the total costs of the network must be apportioned among all users. The average cost measure makes it easier to accomplish this; by multiplying average cost by some measure of an interconnector's use of the element (e.g., number of subscribers or calls), the interconnection cost for each user can be calculated. We discuss this in more detail below. NTIA's LRAIC is long run in the sense that it includes the capital costs necessary to provide the element at least cost, given the existing network configuration. NTIA does not, however, favor a green field approach to interconnection pricing, as that will understate the ILECs' true cost. To the extent that the "forward-looking" component to Justice's TSLRIC contemplates a green field approach, NTIA urges that it be used as a lower bound to structure negotiations between LECs and interconnectors. NTIA and Justice agree that interconnection rates must reflect joint and common costs. See id. at 27 (continued...)

their economic [*26*]of production for the service in question,[47] including capital costs[48], without also recouping costs incurred solely in the provision of other services. NTIA readily acknowledges, [*27*] however, that given the

---

[46] (...continued)
("TSLRIC rates may need to be adjusted to permit recovery of forward-looking and common costs that may not be included in the sum of element-by-element TSLRIC rates"). In sum, if Justice is, in fact, not suggesting a green field approach to interconnection pricing, our approaches are quite similar.

[47] The service in question here is, of course, telephony service. Consequently, the derivation of an IELC's LRAIC must not include investments "in facilities 'over-designed' to enable the present or future delivery of cable television or other video services, 'official networks' overdesigned to facilitate the potential future provision of interexchange services, and other investments designed to meet the expected incremental demands or technical requirements of non-basic or enhanced services." Comments of AT&T Corp. at 59.

[48] In the long run, all costs, including capital costs, are variable. Long run costs include a "fair" return on invested capital. This return is correctly thought of as a cost; if it were not paid, those investment dollars would migrate to other opportunities that did pay a fair return. Long run costs must, therefore, reflect the opportunity cost of capital. This also includes the ILEC's costs of unbundling.

The reference to incremental cost leaves open the "size" of the increment. To the extent that average costs vary with the quantity of service produced, the increment should be each additional unit of service provided (i.e., each additional customer). In practice, however, it may be difficult, if not impossible, to measure long run average cost at such a fine level. Instead, the regulator will likely treat the entire service or functionality (all subscribers served) as the increment, and estimate average costs by dividing the total long run costs associated with the service (or functionality) by the number of subscribers.

informational asymmetry between ILECs and regulators, it may be difficult to calculate LRAIC accurately.

For that reason, we believe that the Commission should establish pricing principles that define a "zone of reasonableness" within which negotiating parties may seek interconnection and unbundling rates. That zone should be defined at the bottom by TSLRIC.[49] Its upper limit should be established through a "bottom-up" approach beginning at TSLRIC.[50] An ILEC would have an opportunity to demonstrate by clear and convincing evidence that the TSLRIC estimate should be adjusted to include additional costs -- joint, common, or other[51] -- that: (1) contribute to a ILEC's long run average

---

[49] To the extent that State regulators are certain that an ILEC has little incentive to reach interconnection agreement or has too much bargaining power over potential interconnectors, the threat of TSLRIC pricing may be an effective motivational tool. We prefer reliance on voluntary negotiation to establish interconnections terms. As discussed below, in many cases, the Act contains sufficient incentives for both interconnectors and ILECs to reach agreement. We also recognize, however, that State regulators may need latitude to determine interconnection rates in those instances when voluntary negotiations fail. See, e.g., Washington Util. & Transp. Comm'n v. US West Comm., Docket No. UT-950200, Fifteenth Supp. Order 89 (Apr. 11, 1996).

[50] Here we allude to TSLRIC estimates that do not already include an "overhead factor" to account for shared costs. For Hatfield's most recent estimates, the regulator would subtract the six percent overhead factor to recover "pure" TSLRIC estimates. ILECs would be required to justify costs in excess of these lower estimates.

[51] As the Justice Department points out, TSLRIC should be adjusted upward to account for forward-looking joint and common costs, whenever such costs exist. DOJ Comments at 27, 31-32. NTIA believes that the Commission should determine what permissible categories of such joint and (continued...)

[*28*] incremental cost of the services used by an interconnection and; (2) can be justified to the regulator as being clearly incremental to the provisioning of the service or functionality at issue, but is not part of the TSLRIC estimate for that service or functionality.[52]

The above procedure leaves open the question of whether, and if so how, to recover any differences between historical costs and TSLRIC's forward looking costs. Clearly one should consider for recovery only those costs that the ILEC can demonstrate convincingly to the regulator are incurred in service provisioning. Moreover, clearly the ILEC may not be entitled to recover any or all of its embedded costs, no matter how prudently incurred. First, the regulator should require the ILEC to mitigate these costs in instances where greater efficiency can be gained through the existing network. Secondly, any additional benefits that the ILECs gain as a result of changes in the regulatory environment should be taken into account (e.g., benefits from interLATA entry). There may be some remaining shortfall, but its size, of course, will not be determined for a number of years, certainly until after interLATA entry. As a result, if the shortfall is to be recovered at all it would be unwise to include it in input prices before the size of the shortfall is better known. Finally, we note that if there are [*29*] any historical costs that should be recovered, it is preferable to recover them through input prices as a last

---

[51] (...continued)
common costs are.

[52] See Bridger Mitchell, Werner Neu, Karl-Heinz Neumann, and Ingo Vogelsang, "The Regulation of Pricing of Interconnection Services" at 116 (Mitchell et al.) (on file with NTIA).

resort only. Recovery through input prices should be done only through a competitively neutral manner.

The price negotiated by the parties could fall anywhere within that zone of reasonableness.[53] NTIA expects that the parties will bring to the negotiation their assessments of how the relevant State commission will apply the Commission's pricing principles to define the zone in particular circumstances.[54] Each party's assessment of the State regulators likely decision will be an important component of its bargaining strategy, because that assessment will establish the odds of having unfavorable pricing terms imposed upon them. In this way, Commission-established principles for establishing the zone of [*30*] reasonable prices would increase the parties' incentives to negotiate in good faith.[55]

---

[53] The same would be true of a rate fixed by the State via arbitration.

[54] The RA [Regulatory Authority] should indicate that, if no agreement was reached and it were asked to make an ex-post determination, it would determine a charge in that range on the basis of its assessment of the demand conditions in that market. This would provide proper incentives for the two sides in the negotiations. Not knowing what the RA would do in case of failure of negotiations, both would have a preference to reach a settlement on their own accord. Of course, if either party speculated that it would have a good chance that its view on charges would be confirmed by the RA, it might opt to let negotiations fail and rely on the RA's decision. This would have to be accepted as a legitimate part of the process.

Mitchell et al., supra note 52, at 114.

[55] NTIA believes that the prospect of interLATA entry will give the BOCs, at least, incentives to negotiate in good faith. We recognize, nevertheless, that the BOCs' incentives in this respect may decline after they (continued...)

The Commission can strengthen those incentives by promulgating some basic rules for State commissions as they arbitrate contested negotiations. If one or more party requests State commission arbitration concerning the rate for a given interconnection arrangement for unbundled network element, the regulator should begin by defining, consistent with the Commission's pricing principles, the upper and lower bounds of the zone of reasonableness for that item. If both parties' [*31*] proposed rates lie outside of the bound, the State commission should either send the parties back for further

---

[55] (...continued)
have been certified to provide interLATA service. Interconnectors may be protected, to some extent, by the BOCs' existing agreements in that market. To the extent, however, that those agreements are unsuitable for the late entrant, the State regulator may have to choose rates in response to failed negotiations. In extreme circumstances, we see no reason why the Commission could not revoke an ILEC's certification to provide interLATA service.

In general, we favor agreements that give ILECs no incentive to alter their behavior after receiving interLATA certification. Self-executing contracts, which spell out penalties for readily observable ILEC violations with regard to service quality, may be helpful. If these are among the first contracts signed by IELCs, the self-executing provisions may also afford protection for subsequent entrants.

We also strongly recommend that the Commission include as part of the public interest standard governing OBC interLATA entry under Section 271 a requirement that the BOCs have in place processes and procedures for on-going interconnection negotiations, that they have established a practice of bargaining in good faith, that their agreements with interconnectors be self-enforcing, and that their business dealings pursuant to those agreements be found to be in good faith.

negotiation or choose a rate that falls within the zone.[56] If one of the proposed rates is within the zone and the other is not, the regulator could either opt for the inband price, or allow the party who lies outside the band to make a final offer within the zone.[57] If both offered prices are within the zone, the Commission should require that the State regulator choose either of the two prices.[58]

D. Allocating Costs Among Services and Interconnectors

As alluded to above, assigning costs to individual services or functionalities is difficult in the presence of substantial [*32*] shared costs. One way to handle this problem is to compute a percentage mark-up on the LRIC of each service, as Hatfield does. Although Hatfield employs a six

---

[56] Once a price for an interconnection arrangement or unbundled network element has been established, whether by negotiation or arbitration, that rate ought to become the ceiling of the zone of reasonableness in subsequent negotiations between the same parties about the same arrangement or element. In other words, in any negotiation triggered by the expiration of an interconnection agreement, the zone of reasonableness for the rates for any arrangement or network element that was part of the old agreement will be defined by TSLRIC and the applicable rate in the expired agreement. It would be reasonable, however, to permit some flexibility in that upper bound to reflect changes in ILEC costs over time. One solution, at least for price cap regulated ILECs, would be to allow adjustments to the upper bound in accordance to the price cap escalator formula applicable to the ILEC involved. The parties would remain free, of course, to negotiate (and a State commission could establish) a new rate within the new zone of reasonableness.

[57] This latter option would minimize the chance of a mistaken choice in those instances where, for example, one party's price lies at one extreme of the zone and the other party's offer falls just outside the other extreme.

[58] See Notice 268 (requesting comment on "final offer" arbitration).

percent mark-up, that estimate may not be reasonable for all ILECs. If the size of total shared costs is known, one could conceivably calculate the unique percentage mark-up applied to all services such that shared costs are just covered. In practice, it would be wise for the State regulator to employ a relatively low estimate of shared costs in the lower bound of its price band for a service (e.g., Hatfield's), a higher estimate in the upper bound, and then permit the parties to arrive at a mutually beneficial arrangement through negotiation.[59]

Another potential problem arises in apportioning LRIC among users (both interconnectors and the incumbent ILEC) who share a facility. The TSLRIC methodology, for example, derives cost estimates for an entire service or functionality; it does not specify how that total cost should be apportioned among users.[60] [*33*] The costs of a shared facility should be

---

[59] A similar approach is suggested by Mitchell et al.:

> The percentage mark-ups on top of LRAIC for interconnection services should vary between zero, as the lower limit, and, as the upper limit, the minimum uniform mark-up, that is, that common mark-up that, when applied to the LRAIC of each service, would lead to revenues that cover all costs, including common costs, and all other revenue requirements.

Id. at 113.

[60] One could, conceivably, compute the ILEC's total costs before and after it provided a service or functionality to an interconnector to determine that entrant's individual TSLRIC. The same interconnector, however, might face different TSLRICs depending on when it entered the market. That is, the first entrant might face a relatively large TSLRIC, as the ILEC reconfigured its network to accommodate interconnection while subsequent entrants might bear much lower burdens. We think it best, therefore, that

(continued...)

apportioned based on the capacity required by the individual interconnectors:

> Pricing would be capacity based if a user paid at each point of time in relation to the depreciation charges for that part of the capacity that, either at the time of investment, or at the latest revaluation of the asset because of changing market conditions, was "reserved" for him....It would...not be unrealistic to apply capacity-based pricing to large users, in particular interconnecting network operators. Such users have predictable consumption patterns. . . Capacity-based costing would not preclude charging for operating costs on the basis of actual usage with which this kind of cost varies. Nor would it preclude, of course, charges based on actual usage if the latter exceeds the capacity that was reserved for the demander.[61]

In New York, parties have negotiated capacity-based pricing arrangements that employ measures of actual usage. Under the NYNEX-Teleport Agreement:

---

[60] (...continued)
the ILEC compute a comprehensive TSLRIC for a service, and then apportion that cost among users.

[61] Mitchell et. al., supra note 52, at 106.

> The general form of the agreement is to establish a particular charge for a two-way channel of given capacity between the two companies. Traffic is measured at the busy hour each month and the relative measurements are used as an allocation factor for the established channel rate. If traffic is exactly balanced, the payments to each company cancel out and the level of the established rate is irrelevant. If traffic is not balanced, and if Teleport, for example, sends more traffic to NYNEX than it receives [*34*] from NYNEX at the busy hour, that imbalance is used to compute a net payment from Teleport to NYNEX.[62]

As Brock and others have noted, the distinction between peak and off-peak traffic (1) provides an administratively simple way to calculate contributions from firms and (2) promotes economic efficiency because costs are "generally associated with peak traffic and therefore the effectively zero charge for terminating off-peak traffic is cost based."[63] Again,

---

[62] Gerald Brock, "Interconnection and Mutual Compensation With Partial Competition," in The Economics of Interconnection 14 (Apr. 1995) (prepared for Teleport Communications Group).

[63] More generally, Brock notes that:

> If the established price for a channel of given capacity is near the real cost, then the NYNEX-Teleport arrangement provides an attractive model for general interconnection issues. It would approach a cost-based interconnection fee for both peak and off peak traffic, leading to economic efficiency and opportunities for pricing innovations.

Id. at 15.

the exact method for sharing costs among users should be agreed upon through negotiation and may vary across markets. The NYNEX-Teleport agreement is but an example of a usage-based agreement that promotes economic efficiency.

REPLY AFFIDAVIT OF PROFESSOR JERRY A. HAUSMAN

* * *

[*5*] 7. In its description of TSLRIC, AT&T calls for the "most efficient technology" so that the "less efficient" COS technology that it sold to ILECs would not be covered. At the time the ILECs bought the AT&T COS, they were widely considered to be the best technological choice, see e.g. Hausman and Kohlberg (1989). Because the switches were a sunk investment, AT&T's recommended method to set prices at TSLRIC would not allow recovery of an efficient investment in 1990 which is "not efficient" in 1996 due to technological progress. AT&T's argument that all firms face risk from changing technology (p. 71) is correct; but firms which face these risks build a risk premium into their prices. Regulation has not permitted ILECs to build in the risk premium. Indeed, improper depreciation lines set by regulation has led to too slow capital recovery even in a world of certainty.

8. I now account for the sunk nature of the investment and uncertainty. Given the fundamental uncertainty and the sunk nature of the investment, a "reward for waiting" occurs because over time some uncertainty is resolved. The uncertainty can arise from at least 4 factors: (1) Demand uncertainty; (2) Price uncertainty; (3) Technological progress (input price) uncertainty; and (4) Interest rate uncertainty. Now the fundamental decision rule changes to:

$$P^* > \frac{\beta_1}{\beta_1 - 1} (\delta + \lambda) I \qquad (2)$$

where $\beta_1 > 1$ so that $m = \beta_1/(\beta_1 - 1) > 1$. The parameter β_1 takes account of the sunk cost nature of the investment coupled with

inherent economic uncertainty.[6] Parameter m is the mark-up factor required to account for the effect of uncertain economic factors on the cost of sunk and irreversible investments. Thus, the critical cuts off point for investment is $P^s > P$ from equation (1).

9. To see how important this consideration of sunk costs can be, I need to evaluate the factor m. The parameters $ß_1$ and m depend on a number of economic [*6*] factors. It can be demonstrated that as uncertainty increases, i.e. the variance of the underlying stochastic process , $ß_1$ decreases and the m factor increases. Also, as δ increases, $ß_1$ increases which means that the m factor decreases. As r increases $ß_1$ decreases so that the m factor increases. Dixit and Pindyck (1994, p. 153) calculate m = 2 so that, for instance, $V^s = 2I$.[7] A TSLRIC calculation which ignores the sunk cost feature of telecommunications network investments would thus be off by a factor of two. Using parameters for ILECs and taking account the decrease in capital prices due to technological progress (which Dixit and Pindyck assume to be zero in their calculation) I calculate the value of m to be around 3.2-3.4. Thus a TSLRIC calculation which ignores sunk costs for telecommunications networks is

[6] I do not derive this equation here since it is the solution to a differential equation. For a derivation see e.g. Dixit and Pindyck (1994), pp. 254-256 pp. 279-280, and p. 369. The parameter $ß_1$ depends on the expected risk adjusted discount rate of r, expected exponential economic depreciation δ, and the net expected price -a and the amount of uncertainty.

[7] Ingersoll and Ross (1992, p. 12) for a 20 year project, which seems about right for network investment, calculate an adjustment factor of about 2.2 times. This calculation considers only interest rate (price) uncertainty, and does not account for technological change.

systematically downward biased by a factor of at least 2, and the factor probably exceeds 3.[8]

10. A TSLRIC calculation would now miss two components which would lead to a systematic downward bias: (1) price decreases in investment due to δ, which represent changes in technology and (2) the sunk cost factor in telecommunications networks combined with inherent economic uncertainty. Combining these two omitted factors in a TSLRIC calculation demonstrates that the systematic downward bias can be substantial. For reasonable values of the parameters, TSLRIC can be biased downward by a factor of over 3. As an approximation, the discount rate would need to increase by the same factor to [*7*] give the correct rule for investment decisions by a firm facing competition.

* * *

[*8*] investments and uncertainty are socially optimal. By assuming away uncertainty and not discussing the free option that they would give to CLECs (and which Ingersoll and Ross (1992) demonstrate is very valuable), BOW are not capturing

[8] Thus, Sprint's proposal to use the federal rate of return in a TSLRIC calculation (p. 45) neglects the sunk cost component of the investment and would lead to badly biased results. Consider the following example. Hewlett Packard (HP) makes microprocessors which are used in work stations which it sells to its competitors who also manufacture work stations. Investment in a new microprocessor fabrication plant is very risky given increasing competition from Intel Pentium class chips. The investment is almost totally sunk. Now HP's hurdle rate is likely 2-3 times its cost of capital. Yet Sprint's proposal would force HP to supply microprocessors to it based on the cost of capital, not on the hurdle rate.

all of the costs imposed on the ILECs by the CLECs.[11] Thus, their recommendation leads to economic inefficiency and a socially sub-optimal outcome.

B. Efficient Entry Decisions

13. The DOJ claims that a second advantage of a pricing standard based on TSLRIC is the "creation of the 'right' investment incentives for competitive facilities-based entry" in terms of the "entrant's 'make or buy' decision with respect to network elements (DOJ, p. 29). The DOJ is again incorrect because it has failed to take account of the effect of sunk and irreversible investment together with uncertainty. The typical rule based on certainty or no sunk costs says to invest if the operating cost plus the cost of capital is less than the price: $C + rI < P$ or equivalently $(P - C)/I > r$. However, suppose future demand is uncertain so that future price is also uncertain. If you invest in a sunk and irreversible capital good and the price decreases sufficiently, you can be left losing money because the capital good cannot be used elsewhere. Thus, for sunk investments one expects a firm to have a rule of $(P - C)/I > mr$ where $m > 1$. Now TSLRIC sets the cost equal

[11] An example may clarify this situation. Suppose that a customer of microprocessors approaches a manufacturer and wants to negotiate a price for a custom made chip which will require a dedicated sunk cost investment whose economic lifetime is 10 years. Under usual competitive situations, if the customer commits to buy a guaranteed number of chips over the next 10 years, the price will be much lower than if the customer only commits to buying the chips for 1 year. BOW's description of the basic principles of estimating TSLRIC (pp. 9-13) would lead to the same estimate regardless of whether the contract was for 1 year or 10 years. However, the efficient economic outcome and the price will very much depend on the contract terms of which party, in fact, does bear the risk. Thus, BOW's neglect of uncertainty is contradicted by actual market outcomes and does not correspond to economically efficient outcomes that are observed in competitive markets.

to $C + rI$ so it sets $m = 1$, which is incorrect. The size of m depends on underlying economic factors and the amount of uncertainty as before, but as the above calculations show, m can be quite large.[12]

[*9*] 14. Thus, contrary to DOJ's claim, TSLRIC-based network element prices will set too low a signal for facilities-based investment. The new entrant, which also must account for sunk investment and uncertainty, will buy too much from the ILEC which reduces productive efficiency if the new entrant could have done the investment more efficiently.[13] Society's resources will be wasted.

15. Again, I point to two real world economic outcomes which this theory explains. When the US dollar exchange rate rose rapidly in the early 1980's, economists were puzzled that foreign imports to the US or investment in manufacturing capacity in the United States did not increase as quickly as economic theory would have predicted. According to purchasing power parity (PPP) calculation, the dollar was highly over-valued. However, when Baldwin and Krugman (1989) took account of sunk costs of manufacturing investment and uncertainty, they realized that a significant premium to the

[12] Dixit and Pindyck (1992, p. 260) explain the entry decision: "If competitive firms adopted the rule of entering when the price reached P_0 [equivalent to the TSLRIC set price], they would earn a normal return only at those instants when entry was taking place -- they would earn lower return at all other instants. The average return over time would then be insufficient to justify the initial investment expenditure."

[13] BOW's discussion of entry decision and make-or-buy decision (p. 5) is correct when they say the expected costs of expansion or entry are compared to the expected incremental revenue. But with uncertainty the expected cost must contain a component which reflects the uncertainty combined with the sunk cost investment. TSLRIC does not capture this uncertainty, but instead assumes a certain outcome.

investment cost had to be taken account of, because the exchange rates could certainly decrease as well as increase. Similarly, for exit decisions from an industry, outdated economic theory says that a manufacturer should shut down if its variable costs exceed the price of the product. Yet, during recessions we see, for instance, that Ford continued to make cars despite suffering enormous losses (not accounting for depreciation). The explanation arises because Ford has tremendous sunk costs in its manufacturing plant and even more important sunk costs in its dealer network and reputation and name recognition with consumers. If Ford had shut down in 1982, much of this sunk investment would have been lost if Ford later decided to re-enter the industry. When demand increased again, Ford would have to make many new sunk investments to restart its operation. The modern economic theory of sunk costs and investment explains why Ford did not shut down. [*10*] The IXCs and DOJ make no mention of the sunk-cost effects in their argument for TSLRIC. This neglect of modern economic analysis causes them wrongly to claim that TSLRIC prices will lead to efficient entry decisions. In actuality, TSLRIC set network element prices will lead to too little facilities based entry and will lead to lost economic efficiency and a waste of society's resources.

C. The "Competitive Market" Standard

16. The DOJ (pp. 28-29) advances a "competitive market" standard for the provision of network elements to new entrants, CLECs. However, the DOJ adopts the perfect information and no uncertainty approach to competitive markets and ignores sunk costs. Thus, DOJ's advice is similar to a perfect competition type of outcome. It is important to recognize that no network industry ends up anywhere close to this outcome of perfect competition. Sunk costs and externalities which arise from networks ensure that the perfect competition outcome will not occur. Highly imperfect

competition is the expected outcome -- e.g. airlines in transportation, ATM networks in banking, credit payment networks, and operating systems for computers (where applications must interconnect). To attempt to impose a theoretical ideal through regulation, on a real world situation in which the ideal cannot occur because of technology, leads to inefficient economic outcomes.

17. The Telecommunications Act of 1996 establishes other factors which will make telecommunications depart even more from how even an imperfectly competitive industry typically operates. None of the industries discussed above has a universal service obligation, e.g. Microsoft is not required to make certain that 95% of residential customers have a computer and use Windows. Similarly, no airline is required to provide cross subsidies to residential customers by pricing below cost. No airline is required by Congress to charge the same amount for a 200 mile flight as for a 2000 mile flight (rate averaging). Nor are banks required to provide free service to a given group of customers as ILECs are required to do for information service providers. Thus, the "competitive market" ideal, in terms of perfect competition, is far from the actual situation, especially as applied to local exchange service obligations of [*11*] ILECs. As an economist, I certainly favor increased competition in telecommunications. However, a realistic view of the competitive structure engendered by the technology and regulatory and legislative obligations imposed on the ILECs provides the economic constraints in its policy recommendations. Neglect of these real world policy considerations is not the correct approach.

18. Similarly, the Hatfield model submitted by MCI assumes a "start from scratch" world where technology has never changed, no uncertainty exists, and no firm ever made an investment without correctly predicting how technology would change. However, in the real world of uncertainty and

asymmetric information companies do make mistakes. For example, the 1982 AT&T prediction that by the year 2000 only 1 million cellular subscribers would exist and the 1985 decision by MCI to sell off all of its cellular spectrum at about $25 per pop were both multi-billion "mistakes". Yet, the Hatfield study does not allow for these "mistakes", and instead says that the new entrants should get all of the benefits of uncertainty. Thus, Hatfield wants the ILECs to bear all of the risk and the CLECs to get all of the rewards of uncertainty.

19. Under this situation, the ILECs' incentive will be to invest too little and the 1996 Act's explicit goal "to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans" will not occur. Correct investment incentives must take account of the technological uncertainty and the sunk costs of investment to provide the correct economic incentives for ILECS and new entrants to invest.[14]

[14] The Hatfield study's reliance on TSLRIC is incorrect for the same reasons that the IXC's and DOJ's reliance is incorrect. Further, the Hatfield study proposal would not allow for recovery of joint and common costs which the DOJ does recognize should recovered by the ILECs.

REPLY AFFIDAVIT OF ROBERT G. HARRIS

* * *

[*5*] In a fully competitive local exchange market without carrier-of-last resort or ready-to-serve obligations, U S West would be free to negotiate mutually beneficial network build-outs for end-user customers or for resellers, based on term commitments and "take or pay" clauses which would allow U S WEST to recover the cost of its investment.

C. Embedded Costs and Uneconomic Depreciation of ILEC Assets

Several of the parties claim that the fact that incumbent LECs' embedded costs are in excess of TSLRIC is evidence that ILECs have not been operating efficiently.[4] In fact, there are two main reasons why incumbent LECs' embedded costs appear to be so much greater than TSLRIC. First, as will be explained in the next section, the gap is evidence of how grossly the Hatfield model underestimates TSLRIC. Second, ILECs' embedded costs are greater than even correctly estimated forward-looking costs because depreciation rates have been set at uneconomic levels by state regulators.

Regulators have consistently required that U S WEST use longer asset lives than it would have chosen for itself, which has resulted in accumulated "uneconomic" costs and potentially stranded investment. Table I below provides a point of

[4] AT&T, for example, claims that "There is every reason to believe that ILEC architecture, sizing, technology, and operating practices, by contrast, have routinely departed from efficiency." AT&T's Comments in Response to the NPRM at 57-58, Docket No. 96-98.

comparison between U S WEST's regulated depreciation rates and the economic rates used by competitors for three different types of plant in the state of Washington. Clearly, in many instances, U S WEST is forced to depreciate its investments at uneconomically slow rates.

[*6*] Table I: Comparison of Depreciation Lives as of 1995 (in Years)

Company Name	Digital Switching	Digital Circuit	Fiber Optic Cable
AT&T	9.7	7.2	20
Electric Lightwave	10	10	20
Teleport	10	8	20
US WEST Intrastate rate in Washington	18	13	30

Source: U S WEST State Regulatory Filing in Washington

In a stable, regulated environment, prescribed lives protected consumers from rate shocks that could otherwise have been caused by early retirement of telephone plant, and the negative impacts of those prescribed lives were minimal: (1) competition was not harmed because competition was not a significant factor; and (2) shareholders were protected by regulatory accounting principles, which allowed U S WEST to set prices to recover the cost of capital investments, even after telephone

plan was retired. However, with competition emerging, state jurisdictions no longer offer a "monopoly franchise," and shareholders are at risk when depreciation rates are understated.

In competitive markets, depreciation rates reflect the true economic lives of the assets to which they correspond. Therefore, in competitive markets, embedded costs based on accurate economic depreciation rates are, by definition, equal to "forward-looking" costs, because economic depreciation rates anticipate and account for the changes in technology, substitute products and competitive conditions that affect the economic lives of assets. Thus, the fact that ILECs' embedded costs are so much greater than TSLRIC can only indicate that depreciation rates have continuously been set too low. Hence, in the current environment, the principles of causality and realism in cost estimation necessitate the use of economic depreciation lives, rather than the uneconomic lives prescribed by regulators, in estimating TSLRICs.

[*7*] The harmful effects of using artificially long prescribed depreciation lives are likely to increase dramatically in the near term. With the convergence of disparate technologies for providing local exchange services, it is highly likely that economic lives will shorten even further, increasing the disparity between prescribed and economic depreciation rates. For example, the upgrade of cable TV plants to offer interactive broadband services will drastically reduce the economic lives of U S WEST's local loops. U S WEST must also consider the increasing likelihood of stranded plant as competitors gain market share, especially if competitors are able to win discrete geographic areas, thereby displacing U S WEST as the primary facilities-based provided in those areas.

In an increasingly competitive telecommunications market, if U S WEST is able to make network investment decisions based on its own business strategy without asymmetric regulatory requirements, it will set its own depreciation lives based on its own best estimates of market conditions. If the company miscalculates, or if it chooses to depreciate its assets at an artificially low rate, it may very well have to write-off parts of its sunk investments.[5] However, all of the sunk investments and subsequent write-offs made by companies in competitive markets are dictated by market and technological forces, not regulatory policy. Thus, such companies are not entitled to protection from market-based write-offs.

However, these write-offs resulting from independent business decisions by unregulated companies are fundamentally different from those resulting from past regulatory policy decisions designed to reduce the cost of basic local exchange service. U S WEST should be allowed to recover embedded costs from investments it was required to make under its carrier-of-last-resort and ready-to-serve obligations, especially since the rates of depreciation have been intentionally slowed by regulators to keep local exchange rates down.

[*8*] D. TSLRIC Estimates Should Be Based on Realistic Assumptions

MCI contends that TSLRIC "should serve as the standard for rates charged for unbundled elements" and that "[t]hese rates should be established by the Commission as presumptive price

[5] There are many instances in competitive industries where companies have misjudged the economic lives of their investments, thus temporarily overstating their profits until they were forced to write-off those assets. Coca-Cola, IBM, and Ford are good examples.

ceilings." MCI proffers TSLRIC cost estimates from the Hatfield model as "evidence" that "access rates are currently well in excess of economic cost."[6] In this section, I will show that the Hatfield model is based on highly naïve, fatally flawed assumptions about the cost of providing local exchange services, given the strict ready-to-serve obligations and service quality standards imposed on ILECs. In the last section of this reply affidavit, I will explain why, even if correctly estimated, TSLRIC should not be used as a price ceiling for any telecommunications service, including interconnection and unbundled network elements.

The AT&T/Hatfield conceptualization of TSLRIC is fatally flawed. According to AT&T:

> "The economic costs to be measured are the costs an efficient, cost-minimizing competitor would incur — i.e., the costs of assets that are optimally configured and sized with current technology and efficient operating practices. The past architecture, sizing, technology, or operating decisions of the IELECs should not serve as bases for calculating TSLRIC."[7,8]

[6] MCI's Comments in Response to the NPRM at iii, Docket No. 96-98.

[7] AT&T's Comments in Response to the NPRM at 57-58, Docket No. 96-98.

[8] It should be noted that contrary to AT&T's assertion, some state commissions have already permitted the use of existing network architecture to estimate TSLRIC. For example, as defined in the Colorado cost and pricing rules, "[A]n estimate of total service long run incremental cost can be generated by assuming that the geographic locations of routes and

(continued...)

Yet in no industry I have studied is it possible to build capacity "optimally" in anticipation of future demand, technological change, etc. Airlines continue to fly older, less fuel efficient aircraft; manufacturers continue to use older production plants, even though newer, more efficient technology is available. Moreover, producers seldom build "whole new facilities" starting from scratch. It is far more common for capacity investments to be limited by current locations, existing technologies, and the need to modify, modernize and expand existing facilities. If AT&T were correct that competition drives prices to the "theoretical" minimum cost of production, no firm could survive – nor would any [*9*] firm invest in capacity in the first place. Competition tends to force prices toward those costs that are realistically achievable, given the realities and limitations of building and operating production facilities.

Additionally, the Hatfield model does not reasonably estimate TSLRIC given real world build-out requirements. The Hatfield model of TSLRIC divides the local exchange service area into six different cost zones based on differing population densities. However, in a highly unrealistic further simplification, the model assumes that customers are evenly distributed in each of the zones. This even distribution is clearly not realistic, and this misguided assumption serves to grossly underestimate real world costs of building local exchange networks. Additionally, the Hatfield model assumes all network build-outs occur in a greenfield environment, to serve new housing developments or

---

[8] (...continued)
possible switching locations are the same as those available to the firm today and that the types of technological change in the future can be anticipated." Colorado Cost and Pricing Rules Adopted in Docket No. 92R-596T, Rule 2(45) (b).

office parks. Yet, in reality, a large share of telephone plant is not installed in greenfield situations. Many network build-outs occur as infills in previously built-out areas, for example, when old warehouses are converted to office suites or residential lofts, or when formerly single line residential customers begin demanding multiple lines for fax, modem and Internet access. Such retrofitting, which requires streets to be torn up and preexisting buildings to be modified, is far more expensive than the idealized greenfield build-outs assumed by the Hatfield model.

Moreover, the Hatfield model ignores the extraordinary asset-specificity of local distribution facilities by assuming high utilization rates. Telephone switching capacity and transport facilities are relatively fungible. If one end-user does not use a capacity increment, other end-users can use that increment. However, the local loop and its subcomponents, feeder, distribution and drop, are not nearly as fungible, particularly segments which are dedicated to specific users or geographic areas. For example feeder cables, which are dedicated to specific distribution areas (neighborhoods) are fungible within dedicated distribution areas but are highly asset-specific across distribution areas. Thus, if a neighborhood as a whole has higher than anticipated growth in demand for access lines, new feeder cables would have to be laid — an extremely costly process. Distribution and drop are asset-specific to smaller geographic areas and individual premises respectively. It is costly to redeploy distribution and drop (but less costly than laying new feeder cables).

[*10*] It is obviously much more costly to retrofit the network to provide additional lines than it would have been if it were possible to perfectly anticipate growth within and across distribution areas. As land use patterns change (from residential to commercial or from manufacturing to service

sector), demand for access lines can increase dramatically and unexpectedly, imposing unanticipated costs on the local exchange provider and making it very difficult to optimize their network design and build-out. These real world costs must be included in any total service incremental cost estimates for local exchange carriers. Because the Hatfield mode fails to do so, the cost estimates it generates vastly understate the true cost of providing local exchange service under efficient, but reasonably achievable operating conditions.

While the unrealistic and impractical assumptions mentioned above concerning whole builds in greenfield environments and overstated utilization rates are reason enough for rejecting any cost estimates from the Hatfield model, it has a number of other flaws, all of which, not surprisingly, bias downward its estimates of the TSLRIC of local exchange services and network elements. The Hatfield model:

> Incorporates modules from the Benchmark Cost Model (BCM) which exclude distribution plant in urban areas and other network components which have variable investment costs in the long run. These omitted costs are caused by the provision of local telephone service and should therefore be included in a TSLRIC analysis.
>
> Excludes product specific costs such as marketing and product management which are caused by a specific service and thus should be included in TSLRIC study.
>
> Assumes that the design and sizing associated with AT&T's interLATA toll network is relevant for U S WEST's local exchange network. Assumptions about the most efficient technology for connecting tandem switches does not accurately reflect traffic flow volumes

> or utilization factors on U S WEST's local exchange network, which operates with much lower traffic densities than an long distance network.
>
> Violates the "total service" aspect of TSLRIC by relying on inputs from the New Hampshire Telephone Incremental Cost Study for drops and switch maintenance expenses. That model only estimates costs for an incremental expansion of an existing service.

Given these obvious flaws and deliberate costing biases, it is not surprising that the TSLRIC estimates generated by the Hatfield model are well below the ILECs' embedded costs. If the TSLRICs were truly equal to those estimated by the Hatfield mode, the ILECs' existing facilities would not represent [*11*] an advantage to the ILECs, but rather a tremendous liability. Since ILECs' embedded costs are so much higher than the TSLRIC proposed by the Hatfield mode, new entrants would easily be able to take significant market share away from the ILECs by building new facilities at the Hatfield cost, well below the ILECs' costs, and then selling the services for the lower price that would result. If the Hatfield cost estimates were accurate, AT&T would not hesitate to build its own network. Yet, instead, AT&T demands unbundling because they claim the cost of building their own networks would be too high. In this sense, the cost estimates generated by the Hatfield model contradict the basic premise of unbundling: that because it is not economic for new entrants to build distribution plant to provide local exchange services. ILECs should be required to unbundle their facilities and sell them at TSLRIC.

Moreover, the price of residential exchange service is, in many areas of many states, well above the TSLRIC estimates of the Hatfield model, which suggests that entrants have an economic

incentive to enter the market by building their own facilities. What one observes, though, is that entrants are building facilities only in urban centers and other concentrations of high volume business users, not in residential areas. The reason for that pattern of entry and investment is straightforward: it costs far more to build local distribution plant in residential areas than the Hatfield model estimates. Indeed, I know for certain that U S WEST would gladly procure its distribution plant from Hatfield Associates at prices equal to the Hatfield TSLRIC cost estimates and delivered on a timely basis to protect against "held orders" or other service quality infractions.

The costs of recent additions to plant by U S WEST is a far better estimate of the costs of constructing local exchange facilities than estimates generated by a model based on highly unrealistic assumptions, despite AT&T's claim that "the economic costs to be measured are the forward-looking costs of providing the network element in question, and the ILECs' backward-looking book costs should rarely, if ever, be used as 'proxies' for those forward-looking costs."[9] Just as the forward-looking incremental cost of auto assembly capacity can be estimated by using last year's investment, including "new plants" and modernized or expanded plants, so too is U S WEST's recent investment [*12*] cost a reasonably good estimate of the "forward-looking" cost of local exchange service, because it reflects the actual and difficult field conditions in which and under which local exchange facilities are constructed. For example, the state of Colorado, U S WEST's average embedded cost of constructing a loop in 1995 was more than $30 per month. In contrast to the Hatfield model's average cost estimate of $8.66 per month, U S WEST's

[9] AT&T's Comments in Response to the NPRM at 55-56, Docket No. 96-98.

embedded cost is a much better estimate of the forward-looking cost of efficiently building local loops.[10]

E. If TSLRIC Pricing And Other AT&T Requests Were Implemented, ILECs Would Be Forced Into Severe Financial Distress or Insolvency

AT&T, MCI and others advocate that prices should be set at TSLRIC to replicate conditions in competitive markets.[11] However, competition does not drive prices to the cost of the most efficient producer. An industry supply curve is upward sloping because it reflects differences in the cost of production, from the most efficient to least efficient capacity in the industry. The equilibrium competitive price is equal to the cost of the least efficient producer who is actually producing in the competitive market. In a competitive industry, therefore, one can observe that the least efficient producers earn profits below their cost of capital, while the most efficient producers earn profits in excess of their cost of capital. Were that not the case, there would be no incentive to increase efficiency by investing in new technologies or to expand capacity to meet growing demand.

[10] See AT&T's Comments in Response to the NPRM, Hatfield Model Version 2.2, Release 1, p. 54.

[11] "Prices for telecommunications services should reflect the costs of those services, as they would in a competitive market. This means prices should be set at total long service [sic] long run incremental cost (TSLRIC). This standard will allow the ILEC's to recover the full, forward-looking costs of provide network elements including a reasonable return to capital." MCI's Comments in Response to NPRM at iii, Docket no 96-98

AT&T claims (and the FCC has agreed) that IXCs operate in a competitive market. AT&T also claims that prices in competitive markets equal TSLRIC. These claims therefore imply that AT&T's own prices are set at TSLRIC. However, it is evident that AT&T's interLATA prices can not possibly be set at TSLRIC. A comparison between AT&T's Tariff 12 rates and their basic residential rates shows a tremendous difference in the two prices — approximately 70 percent. This difference cannot be attributed entirely to billing costs. Nor can it be attributed to common or shared costs, since AT&T

[EX PARTE OR LATE FILED]

July 19, 1996

Mr. William F. Caton **[Received Jul. 19, 1996]**
Acting Secretary
Federal Communications Commission
1919, M Street, NW. Room 222
Washington, DC 20554

RE: Ex Parte Presentation
CC Docket No. 96-98
Dear Mr. Caton:

Pursuant to the Commission staff's request, AT&T is submitting the attached response to the Reply Affidavit of Jerry A. Hausman that was appended to USTA's Reply Comments in this Docket. This response was prepared by Professors R. Glenn Hubbard and William H. Lehr of Columbia University.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

/s/ Richard N. Clarke
Richard N. Clarke

Attachment
cc: J. Farrell
G. Rosston
G. Hubbard
W. Lehr

CAPITAL RECOVERY ISSUES IN TSLRIC PRICING: RESPONSE TO PROFESSOR JERRY A. HAUSMAN

R. Glenn Hubbard and William H. Lehr
Columbia University
July 18, 1996
[Received Jul. 19, 1996]

I. Introduction and Summary

In his reply affidavit for this proceeding,[1] Professor Jerry Hausman argues that "TSLRIC should not be the price for interconnection elements for two reasons: (1) it ignores fixed and common costs, and (2) telecommunications are mostly sunk costs." Hausman justifies this second reason using three basic arguments:

(1) TSLRIC prices fail to compensate incumbent local-exchange carriers (ILECs) adequately for past investments;
(2) TSLRIC prices are a theoretical construct which are not realized anywhere and will not be realized in the imperfectly competitive local-exchange markets; and
(3) TSLRIC prices will result in inefficient investment and production decisions in the future, leading to insufficient facilities-based entry.

As we explain below, each of Professor Hausman's arguments is incorrect. His first argument confounds two separate questions leading to unnecessary confusion and an erroneous conclusion. Because TSLRIC prices are forward-

[1] See *Reply Affidavit of Jerry A. Hausman*, In the Matter of Implementation of Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98, May 30, 1996.

looking, they ignore past investments of ILECs *by definition*. This is as it should be because, in competitive markets, only costs that are efficient on a forward-looking basis can he recovered in prices. To the extent that one can show that the ILECs should be awarded additional revenues as part of a "regulatory compact," these revenues should be treated analogously to the need to fund universal service. TSLRIC pricing of interconnection components is designed to induce efficient, competitively-neutral, non-discriminatory investment decisions, not to effect rent transfers or subsidies which are more efficiently and appropriately handled via a separate, competitively neutral mechanism (*e.g.*, a lump sum addition to the subscriber line charge). If these cross-subsidies and transfers are permitted to continue in the future by embedding them in component pricing, then local- exchange competition will not succeed and the Telecommunications Act of 1966 will have failed. While we do not accept Professor Hausman's implicit contention that such a "regulatory compact" did in fact exist, or that the ILECs failed to adequately recover costs that were due them, we do not wish to debate these matters here. This argument and the counterarguments against it are made more forcefully elsewhere.[2]

Hausman's second argument is that TSLRIC prices are inappropriate because they are a theoretical construct[3] and

[2] See, for example, *Reply Comments of AT&T Corporation*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98, May 30. 1996, and June 3, 1996. As noted therein, the courts generally affirmed no obligation to include in the rate base all actual costs for investments which were prudent when made.

[3] Hausman states: "To attempt to impose a theoretical ideal through regulation on a real world situation in which the ideal cannot occur because

(continued...)

because local-exchange markets are not likely to become competitive. Professor Hausman argues that "highly imperfect competition is the expected outcome" (page 10) in a whole collection of network industries such as banking, airlines, and telecommunications. The presence of network "externalities" (page 10) accentuates the market power which accrues to an established incumbent and makes it all the more important that potential entrants be guaranteed efficient, nondiscriminatory, competitively neutral interconnection rights if competition is to survive. Not surprisingly, the industries mentioned by Hausman were at one time heavily regulated (in part to address interconnection and market power issues). Rather than refuting the logic of TSLRIC pricing, the fact that local-exchange markets are not competitive today offers a powerful inducement for its adoption. Moreover, the threat of market power associated with the ILECs' position as dominant incumbents makes it important to include an array of additional regulatory policies in order to facilitate effective competition (*e.g.*, imputation rules to protect against predatory pricing, promoting total service resale and reciprocal termination agreements).[4]

---

[3] (...continued)
of technology leads to inefficient outcomes" (see *Reply Affidavit of Jerry A. Hausman*, note 1, *supra*, page 10).

[4] Throughout his reply affidavit, Hausman makes reference to industry comparisons which do not fit the circumstances of local-exchange markets and are of little relevance to the present proceedings. Occasionally, his examples seem to refute the very point he is trying to make. For example, Hausman claims: "no airline is required by Congress to charge the same amount for a 200 mile flight as for a 2000 mile flight (rate averaging)" (see *Reply Affidavit of Jerry A. Hausman*, note 1, *supra*, page 10). We and AT&T agree that historical regulations have distorted the pricing of retail telephone services; however, this has nothing to do with the appropriateness
(continued...)

Hausman's third argument is the most complex and, if it were true, the most relevant for the present proceedings; we devote the bulk of our comments to its refutation. Briefly, the essence of Hausman's argument is that TSLRIC-based prices will lead to inefficient investment decisions because they fail to take account of (1) *expected* economic depreciation (which exceeds allowed depreciation because of expected technical progress); and (2) the risk associated with *unforeseen* changes in final product demand and prices, capital goods prices, and interest rates. The former point is incorrect, as we explain below. To explain the effects of the latter effect, Hausman provides a simplified and highly stylized example based on contemporary investment theory. Most of the examples and empirical research he cites are designed to show the validity of this theory and its applicability in the modern analysis of efficient investment behavior. Hausman's principal error, though, is to redefine TSLRIC incorrectly to create a straw man, which he can then discredit with highly stylized examples to a complex theory and unsupported and unexplained references to his own empirical estimates.

In Hausman's notation, he implicitly argues that TSLRIC is equivalent to setting component prices equal to $pT = rI + C$, where r is the ILEC's risk-adjusted cost of capital, I is the total investment cost, and C are the operating costs. Hausman argues that even in a world of certainty, prices would need to he higher than P^T to compensate firms for expected economic depreciation and declines in the price of the capital goods. In such a world, the correct pricing rule would be to set price higher than implied by Hausman's (incorrect) definition of TSLRIC. (In the first part of his reply affidavit, Professor

---

[4] (...continued)
of TSLRIC for the pricing of unbundled network elements and for estimating the avoided cost.

Hausman also conveniently assumes that $C = 0$, which has the effect of enlarging on a percentage basis his estimate of the potential understatement of TSLRIC costs.)

Hausman then notes that we do not live in a world of certainty. There may be unforeseen changes in technical progress or factor prices (in addition to the anticipated changes noted above), and perhaps more important, unanticipated changes in firm demand (both because of uncertainty in aggregate demand, and, because of competition, uncertainty in the firm's future market share). By itself, this uncertainty does nothing to change his earlier analysis (since Hausman and others typically assume firms are risk-neutral investors). However, if one assumes that the total incremental cost of investing in local-exchange plant is irreversible and could be postponed, then there is an "option value" associated with "waiting to invest." In such cases, there may be an added "opportunity cost" to investing today which should he taken into account when a firm makes its investment decision.

There are a number of problems with Hausman's application of modern investment theory to critique TSLRIC. First, Hausman has assumed a definition for TSLRIC which is incorrect; as a result, he falsely accuses TSLRIC of failing to account for expected depreciation and possible declines in investment goods prices. He sets up a theoretical straw man by choosing to redefine TSLRIC so that is excludes costs which are clearly included in the TSLRIC concept. He then proceeds to show how failure to include these costs (which actually are included) leads to a gross underestimation of costs. The actual correction is an empirical issue which Hausman addresses by referring to largely unsupported and unexplained examples. On closer inspection, we show how these examples help to refute, rather than support Professor Hausman's arguments. As an empirical matter, we conclude that there is no basis of support for the doubling (or, in some cases, more than doubling) of the

appropriate user cost of capital as suggested by Hausman. If any adjustments to conventional derivations and estimates of the cost of capital are required to address the issues raised by Hausman, such adjustments would be modest.

II. The Logic of TSLRIC

In elementary economics courses, students learn that there are two types of costs in the short run: variable costs, which change with the level of production, and fixed costs, which do not. Economic efficiency requires that prices be set equal to marginal costs so that only consumers who value consumption at least as much as what it costs society to satisfy their demand will actually purchase the good or service. Business school students learn further that profit-maximizing firms should ignore fixed costs in the short run since they are irreversible or sunk. In the long run, all costs are variable and reversible because firms can revisit their decision to continue operating in the industry (*i.e.*, firms could enter or exit the industry). Whether a cost is variable, fixed, or sunk depends on the horizon. In the simplest decision-making framework, a firm chooses whether to enter or exit an industry at a single point in time, which divides the world neatly and unambiguously into the long run (before deciding whether to enter) and the short run (after the firm has decided). The efficient entry decision is for the firm to enter only if the expected future price (post-entry) is greater than the post-entry average variable costs which will be incurred plus the post-entry fixed costs which will be sunk once the firm has entered. The *"P = MC"* rule still applies as long as one understands that P now refers to the expected future price and MC to the long-run incremental cost.

In the real world, decisions occur continuously. Firms may decide to invest, disinvest, or wait to make a decision at a later time, or to reverse wholly or partially an earlier decision

(*e.g.*, by selling off assets). Information is continuously arriving and firms revise their dynamic investment strategies. In this more general framework, the "*P = MC*" rule must be applied by interpreting *P* as the expected average present value price of output and *MC* as the "Total Service Long Run Incremental Cost," or TSLRIC.[5]

The TSLRIC includes all costs which are relevant to the firm when it decides whether to invest in additional capacity (*i.e.*, enter). It is forward-looking by construction because it ignores all costs which may have been incurred in the past and are now sunk. It includes all future costs which result from the decision to enter irrespective of whether they are fixed or variable, or whether they will be sunk following the firm's decision. Because the future is uncertain, the TSLRIC must and does account for uncertainty with respect to technological progress, factor prices, firm demand, and interest rates.

To the extent some of the costs incurred will be sunk, new information arrives continuously, and it is possible to postpone the investment decision until some of the future uncertainty is resolved, there is an option value associated with "waiting to invest," in postponing incurring the sunk investment component. The value of this option should be included in the TSLRLC. The unwieldy acronym "TSLRIC" was created in order to make sure that all relevant, forward-looking incremental costs would be included. Because Professor Hausman conveniently redefines TSLRIC to exclude costs which are clearly included when a proper definition is used, Hausman presents himself with a theoretical straw man which

---

[5] For a more extensive discussion, see *Reply Affidavit of William Baumol, Janusz Ordover, and Robert D. Willig*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98. May 30, 1996, Appendix D.

he then attempts to cut down via recourse to contemporary investment theory.[6]

The acronym "TSLRIC" emerged expressly to deter such simplistic interpretations of the appropriate incremental cost concept to use. It is obvious that Professor Hausman's definition of TSLRIC as equal to just "*rI + C*" is not applicable to the world of telecommunications, which faces significant recurring capital investments which must be recovered for a firm to be financially viable. Thus, Professor Hausman's theoretical criticism of TSLRIC only applies to incorrectly estimated TSLRICs.

Hausman claims that TSLRIC fails to include sufficient allowances for depreciation, and therefore understates efficient prices even in a world of certainty. In order to estimate TSLRIC, one must perform a discounted cash flow analysis of the future costs associated with the decision to invest. This is exactly what the Hatfield model is designed to do.[7] One-time costs associated with the acquisition of capital goods are amortized over the economic life of the asset using the user cost of capital (see below), which requires accounting for both

---

[6] Hausman states on page 4 that "[p]roponents of a TSLRIC price for network elements are attempting to establish a single price over a long period of time." This is not true. TSLRIC is a conceptual basis for estimating forward-looking efficient prices on an ongoing basis. The Hatfield model operates very much in this spirit. For example, if technological progress occurs, it would be tracked in the ongoing updating and periodic review of TSLRIC as estimated by the Hatfield model. The Hatfield estimates could then be used to support decisions made by regulators in their periodic review of prices.

[7] For a description of the Hatfield model, see *Reply Comments of AT&T Corporation*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98, May 30, 1996, Appendix D.

expected capital good price changes and economic depreciation. These effects and the option effect discussed above are incorporated in TSLRIC calculations, and are reflected in the service lives and discount rates used. Perhaps recognizing the invalidity of his claim that, as a theoretical model, TSLRIC neglects these costs, Hausman then attacks the Hatfield model for using parameter estimates based on historical regulatory proceedings, implicitly arguing that the service lives assumed were too long and the discount rates were too low. If true, this would underestimate true incremental costs. However, Hausman provides no evidence that these parameters are biased in the direction he claims, as we describe in section IV. Moreover, attacking specific parameter estimates is not equivalent to attacking a methodology. It is possible to reestimate the Hatfield model using alternative assumptions regarding economic lives and discount rates.

Hausman uses historical data for declines in switch prices from $200 per access line in 1987 to $80 today to demonstrate the importance of including expected changes in capital goods prices. This is misleading on three counts. First, even if one agrees with Hausman's assessment of parameter estimates based on historical rate proceedings, the TSLRIC estimates would still reflect a partial accounting for economic depreciation. Second, TSLRIC is supposed to be based on forward-looking costs. The 1987 price is only interesting in so far as subsequent price declines were unforeseen (which is not obvious) and it may assist in estimating further price declines which should be reflected in the choice of the discount rate and expected economic life for switch assets (which may end up being the same as those used in thc Hatfield model). Third, Hausman focuses on the decline in switch prices, which reflect a much smaller share of total plant in service than is contributed by loop facilities. Because the much more significant nonrecurring costs of loop facilities has declined quite slowly

or may even have increased, it is not surprising that Hausman chose to focus on switch prices.[8]

III. Irreversible Investment Under Uncertainty

Hausman begins his analytical treatment of the effect of sunk cost and irreversibility on efficient pricing with a mischaracterization of thc role of the user cost of capital in the determination of TSLRIC. Absent taxes, the familiar user cost of capital in the neoclassical model is given by:[9]

$$\textit{User cost of capital} = P_k(r + \delta - \Pi_k) \quad (1)$$

where P_k is the relative price of the capital good purchased, r is the risk-adjusted discount rate,[10] δ is the exponential rate of expected depreciation, and Π_k is the expected exponential rate of change in the relative price of the capital good. Equation (1) has a simple interpretation: the user cost of capital is the financial cost of investing funds in a project plus the depreciation of the value of the capital good. Hence Hausman's

---

[8] See *Reply Affidavit of Lee L. Selwyn and Patricia D. Kravtin*, submitted as Appendix C of *Reply Comments of AT&T Corporation*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98, May 30, 1996.

[9] The original derivation of the user cost of capital in the neoclassical model of investment appears in Dale W. Jorgenson, "Capital Theory and Investment Behavior," *American Economic Review* 53 (May 1963), pages 247-255; for a review of the literature since then, see Kevin A. Hassett and R. Glenn Hubbard, "Tax Policy and Investment." Mimeograph, Columbia University, 1996.

[10] The conventional approach to determining the risk-adjusted discount rate is to apply the Capital Asset Pricing Model (CAPM). The discount rate in the CAPM is the sum of the risk-free return and the product of beta and the equity risk premium.

characterization of the user cost of capital implicit in TSLRIC is not correct in so far as he claims that it fails to account for expected changes in prices. Note that while it follows that expectations of falling capital goods prices make straight-line depreciation calculations inappropriate, Hausman's suggestion that depreciation expenses should therefore be higher in all years is incorrect. If capital goods prices are expected to decline (with no change in useful lives), depreciation should be higher in the early years of the life of a capital good and lower in the later years.[11] In addition. Hausman provides no evidence that the prices of capital goods purchased by the ILECs are expected to fall at increasing rates in the future. Indeed, any such evidence would appear inconsistent with the very modest productivity rates that the ILECs' have forecast in the Commission's current price cap proceeding (CC Docket No. 94-1).

The basic neoclassical model has some limiting features, as the research to which Hausman refers suggests. In particular, it assumes that firms cannot delay investing in a particular project (they must undertake the investment or lose the opportunity). Further, it assumes that investment projects are reversible; that is, the capital can be resold in efficient secondary markets. A recent line of inquiry has criticized these assumptions, stressing that firms do often have the option to delay — and, in the presence of certain forms of uncertainty, that option is a valuable one.[12] The second area of emphasis is

---

[11] This point has long been recognized in this context; see, for example, Michael Crew and Paul Kleindorfer, "Economic Depreciation and the Regulated Firm Under Competition and Technological Change," *Journal of Regulatory Economics* 4 (March 1992).

[12] In addition to the option value of delay for ILEC's investments, Hausman notes (on page 2) that the Telecommunications Act of 1996 gives (continued...)

that investment is irreversible; that is, once a capital good is committed to a project it has no resale value.[13] With demand uncertainty and irreversibility, the user cost of capital is augmented by an additional term, raising the value relative to the neoclassical benchmark under certainty.

In the example of Robert McDonald and Daniel Siegel considered by Hausman,[14] the value of a project, V, evolves according to a geometric Brownian motion with drift:

$$dV = \alpha V dt + \sigma V dz, \quad (2)$$

where dt is a time increment, dz is the increment of the Wiener process, and α and σ are constants. The stochastic process for V describes the arrival of new information over time and is consistent with an uncertain future value of V.

---

[12] (...continued)
the CLECs the right, though not the obligation, to use ILECs' capacity investment — thereby granting them an option. While this is true, it is also more generally true that the ILECs also gave their traditional local-exchange customers such "options." Hence as long as prior TSLRIC calculations incorporated adequate capital recovery, substantial additional changes are not warranted.

In contrast to Hausman's unsubstantiated assertion that such options are a one-way bet in favor of the ILECs, should equipment prices increase in the future, TSLRIC would rise and ILECs may increase prices for unbundled elements in the future. Hence there is no one-way bet in favor of the CLEC.

[13] For reviews of models in this line of inquiry, see Avinash Dixit and Robert S. Pindyck, *Investment Under Uncertainty*, Princeton: Princeton University Press, 1994; and R. Glenn Hubbard, "Investment Under Uncertainty: Keeping One's Options Open," *Journal of Economic Literature* 32 (December 1994), pages 1816-1832.

[14] See Robert McDonald and Daniel Siegel, "The Value of Waiting to Invest," *Quarterly Journal of Economics* 101 (November 1986), pages 707-723.

The analytical advantage of this setup is clear from the perspective of Hausman's argument. The investment opportunity considered by the firm is a call option with no expiration date; that is, the firm has the right, though not the obligation, to undertake the project at a pre-specified cost of I. At the same time, this simple setup — on which Hausman relies — has some drawbacks in describing typical investment projects. It assumes that the cost of investment is always I and *infinite* delay is possible, a suspect assumption for telecommunications markets. Also, if there are variable costs, the process for V may not be geometric Brownian motion even if that for the output price is. Finally, if the firm had competitors (Hausman's example derives from the case of a monopoly firm), the process for V may even be more complicated. We return to these concerns below.

In the conventional neoclassical criterion, the threshold value, V^*, is given by $V = I$; the firm invests up to the point at which the cost of investment just equals its value to the firm. The solution to the McDonald-Siegel problem yields a threshold value, V^*, for the project at which the firm should invest:

$$V = [\beta_1/(\beta_1 - 1)]I. \quad (3)$$

The basic intuitive point is this: Irreversibility and the possibility of delay generate a range of inaction (not present in the neoclassical model) in which $V > I$, yet the firm does not invest.[15] (This is because in the solution $\beta_1 > 1$, $[\beta_1/(\beta_1 - 1)] >$

[15] It is important to note that this line of research excludes from consideration strategic motivations in capacity investment — for example, strategic advantages accorded to first movers. Dixit and Pindyck agree that such concerns limit and may reverse the option value of waiting to invest, implying the firm may actually want to invest early, not late (see Avinash (continued...)

1 and $V > I$.) The value of foreclosing the option to delay must be included in the cost of capital, thereby raising the hurdle rate for irreversible investment under uncertainty. This value arises from an asymmetry: delay — waiting for new information — engenders small costs (because the firm is assumed to be able to make the investment later) and potentially large benefits (because costly errors may be avoided).

What are the implications of uncertainty and irreversibility on the threshold output for price for investment? This question pierces the generality in the process described by equation (2) by specifying a source of fluctuations in value — price uncertainty. Suppose that the proposed project produces a physical flow of one unit of output each period in perpetuity. The price depends on the inverse demand function $P = YD(1)$, where D is a measure of nonstochastic flow demand and Y is a stochastic shift variable. In the simplest case, with no variable costs of operating the project, one can write a process for P reminiscent of the geometric Brownian motion used earlier to study V:

$$dP = \alpha P dt + \sigma P dz \quad (4)$$

In this case, the solution for the threshold price at which investment should occur, P^*, equals $[\beta_1/(\beta_1 - 1)]$ times the Marshallian price.[16] Again, there is a range of inaction in which price exceeds long-run incremental cost with no response of investment or entry.

How large is the wedge between traditional net present value investment criterion and that in Hausman's example?

[15] (...continued)
Dixit and Robert S. Pindyck, note 13, *supra*).

[16] See Avinash Dixit and Robert Pindyck, note 13, *supra*, Chapter 6; and R. Glenn Hubbard, note 13, *supra*, page 1823.

Without going into algebraic detail, we can indicate some channels. First, as uncertainty about future returns (measured by σ) rises, the wedge $[\beta_1/(\beta_1 - 1)]$ also rises. Second, all else being equal, an increase in the discount rate, r, increases the wedge. Third, for a given discount rate, r, an increase in the trend value growth α increases the wedge. In the new solution, the user cost of capital rises by an amount equal to $P_k(\frac{1}{2}\beta_1\sigma^2)$.

Under parameter values given by Dixit and Pindyck[17] Hausman conjectures that $[\beta_1/(\beta_1 - 1)] = 2$, so that $V = 2I$. He then concludes that

> "[a] TSLRIC calculation which ignores the sunk cost feature of telecommunications network investments would thus be off by a factor of two. Using parameters for ILEC and taking into account the decrease in capital prices due to technological progress (which Dixit and Pindyck assume to be equal to zero in their calculation), I calculate the value of $m[\beta_1/(\beta_1 - 1)]$ to be around 3.2-3.4."[18]

Hausman offers no justification for his application of the basic McDonald-Siegel problem to the telecommunications case under consideration, nor does he offer any justification for the parameter values he assumes. The major problems with Hausman's calculations fall into two categories, relating to the inapplicability of his simple example to pricing in local-exchange markets and the false characterization of all local-exchange investments as irreversible.

---

[17] See Avinash Dixit and Robert S. Pindyck, note 13, *supra*, page 153.

[18] See *Reply Affidavit of Jerry A. Hausman*, note 1, *supra*, page 6.

In the following three subsections, we justify our critique of Hausman by examining his application of the theory more closely. We first review the theory Hausman cites and show how his choice of examples and parameter assumptions bias his estimates in favor of amplifying his claim that TSLRIC understates true investment costs. We then show how a slightly different analytical model — one which may more accurately reflect the threat of future competition — dramatically reduces Hausman's estimate. The essence of this model is to question the reasonableness of assuming with Hausman that local-exchange investments by the ILEC might be postponed indefinitely. Finally, we argue that Hausman's characterization of all ILEC investment as irreversible is inappropriate and grossly overstates whatever effect irreversibility may have on estimates of TSLRIC.

A. Problems with Hausman's Application of Irreversibility and Uncertainty

In order to take Hausman's example seriously, one would first have to believe that the assumed parameter values are reasonable. The example cited above assumes that there are no variable (operating) costs and that the standard deviation of the annual rate of return on local-exchange investments is 20 percent. Surely, some juslification of these assumptions (taken from an abstract general example from Dixit and Pindyck) is necessary.

Second, as Hausman notes,[19] in the presence of variable costs, C, the investment criterion implied by the new view is:

$$P = mrI + C, \quad (4)$$

---

[19] See *Reply Affidavit of Jerry A. Hausman*, note1, *supra*, page 8.

where $m = [\beta_1/(\beta_1 - 1)]$.[20] The ratio of this price to the Marshallian (neoclassical) price of "$rI + C$" is:

$$\textit{Ratio of Prices} = (mrI + C)/(rI + C) = 1 + [(m - 1)rI]/(rI + C). \quad (5)$$

Hence the size of the operating costs is important for determining the wedge implied by Hausman's calculations. If $m = 2$ - as in Hausman's example - and operating costs are twice as large as capital costs - a more realistic assumption for LECs - the ratio of the prices falls from 2 down to 1.33. Obviously, one could experiment further with parameter values and so produce a range of price ratios in this example.

In some respects, the wedge between the investment criteria in the neoclassical model and Hausman's example is likely to be at its upper bound in geometric Brownian motion examples in which delay can arbitrarily long. While Hausman's example has virtually no relevance for analyzing local-exchange investments, Dixit and Pindyck offer a more germane example which allows for the possibility that the value of the investment, V, will decline discontinuously at some random time in the future. Intuitively, one can think of this as applying to the case where the incumbent local-exchange monopolist has a window of opportunity before other competitors enter and reduce profits and V. Analytically, Hausman's example would be augmented by the possibility of a downward Poisson jump, which would require modification of equation (2) as follows:

$$V = \alpha V dt + \sigma V dz - V dq, \quad (6)$$

where dq, an increment of a Poisson process with a mean arrival rate λ, is independent of dz. When the "jump" occurs, q declines with probability one by some fraction θ (between zero and one). Intuitively, while V fluctuates (with geometric

[20] The example assumes that, in Equation (1), $P_A = 1$, $\delta = 0$, and $\Pi_A = 0$.

Brownian motion), over each interval (dt), there is a probability (λdt) that is will drop a fraction of the original value ($1 - \theta$) and continue fluctuating (with geometric Brownian motion) until the next event occurs. In this case, holding other parameters constant, the option value of delay falls relative to the pure geometric motion example. Using Hausman's calculation as a benchmark, even a 20 percent chance of a loss of economic profits reduces the value of m from 2 to 1.33.[21] While one can obviously design many versions of this experiment, one point is clear: The example used by Hlausman is quite special and overstates the effect of uncertainty and irreversibility on the user cost of capital and the efficient price.

B. Problems with Hausman's Fxample in a Competitive Setting

Hausman's example refers to the problem of a monopolist deciding to invest. For researchers and practitioners interested in empirical applications to telecommunications, however, the lessons of recent investment models would be more compelling if couched in an industry equilibrium. This is because - as a result of market forces and the Telecommunications Act of 1996 - incumbents and potential entrants are engaged in a competitive struggle. The concept of irreversibility is also perhaps more appropriately analyzed at the industry level because the liquidity of most assets in place is surely greater within than outside the industry.

To see the need for this distinction, suppose that investment is completely irreversible and firms expect an industry-wide expansion of demand. A given firm recognizes the qualitative implications of the favorable demand shift for the industry prices and would like to increase its capital stock.

[21] See Dixit and Pindyck, note 13, *supra*, page 173

Of course, the firm understands that other firms will not increase irreversible investment by as much as a monopolist. By contrast, an unfavorable shift in industry demand has a larger effect relative to the monopoly case. Given the assumption (as in Hausman) of complete irreversibility, all firms suffer because exit is not possible. There is, then, an asymmetry in the competitive response to uncertainty because the firm understands that an idiosyncratic demand shift does not imply similar fortunes for other firms, hence the firm behaves like a monopolist.

With regard to Hausman's example,. the "option value" argument becomes more tenuous. Intuitively, there is some price $\underline{P}$, above which entry occurs. Hence any one firm views the price process as described by geometric Brownian motion - as in the Hausman example - as long as $P < \underline{P}$, the price cannot go higher without triggering entry and a price decline.

There are important differences between the cases of monopoly and competitive equilibrium. First, while the monopolist's view of the price process is not affected by potential entry (at least in the example), the competitor's view is. An opposing second effect arises because the monopolist has an option value of waiting, while the competitive firms do not (in competitive equilibrium, the option value is zero).[22] To summarize, while the investment models emphasized by Hausman offer useful insights into determinants of investment, one must be careful to match the design of such models to the particular industry equilibrium being studied.

---

[22] It is still the case in this example that the threshold price for entry is above the usual Marshallian level. In Section III C that follows, however, we take issue with the claim that the ILEC's investments are largely irreversible.

C. Problems with Characterization of all Local-Exchange Investments as Irreversible

Hausman's estimates of higher hurdle rates and prices for LECs require both that investment be irreversible *and* that demand and prices fluctuate significantly. Indeed, Hausman assumes incorrectly that all of the costs associated with local-exchange investments are sunk. This is not true. As already noted, there are significant recurring variable and fixed operating costs. These costs would be avoidable if the firm subsequently decided to exit the industry. More important, while some of the plant investment may not be usable in another application, this is not true of all of the investment. For example, much of the switch and switching center investment is clearly not irreversible. Switches can be moved to new locations and the end-office real estate can be sold. Rights of way, conduit, and even excess wire-line facilities, which may face reduced demand for ordinary telephone lines, may be sold for other uses (such as delivery of video to the home via technologies such as ADSL).[23] To the extent that investments

---

[23] Hausman does not raise another depreciation issue arising from lumpy investments. Because of the discrete nature of many local-exchange investments, it is likely to be efficient to live with underutilization of an asset for a period of time, thereby having capacity to exploit growing demand and realize economies of scale. Conventional regulatory depreciation policy, then, forces current customers to pay for a portion of the capacity put in place to serve future customers. When regulation permitted a local-exchange monopoly and controlled lines of business of the local-exchange firm, current and future customers had significant overlap, so that conventional depreciation policy may have created few distortions However, as local-exchange firms invest for future lines of business, this cross-subsidy made possible by depreciation policy is inefficient. Hence

(continued...)

in local plant are reversible, they do not need to recover the opportunity cost associated with the option to wait to invest (*i.e.*, $m = 1$). Hausman's model assumes that the entire investment, *I*, is irreversible. Because the ILEC could always sell its plant to another firm, a portion of this investment is clearly recoverable. Indeed, at times, ILECs even sell entire exchanges.[24] Finally, evidence about ILEC depreciation suggests that most of the capital stock invested prior to 1990 will soon be replaced.[25]

Using the logic of option values of investment, Hausman argues that a TSLRIC-based calculation gives something free to entrants - the option - while forcing the ILEC to bear the cost of the option. Again, the premise of this argument is incorrect. The firm should use the correctly calculated TSLRIC as a hurdle rate when deciding whether to expand capacity. Presumably this is what the ILECs did when they installed their current stock of plant and equipment. Indeed, most of the ILECs' plant and equipment was installed after 1990, a period in which it is implausible that the ILECs

---

[23] (...continued)
costs of capacity put in place for future services should not be included in the costs of unbundled elements for local-exchange service. TSLRIC-based pricing would for example exclude such costs.

[24] For example, the Iowa Commission recently approved the sale by US West of all of the physical assets associated with twenty-three exchanges. See *Order Granting Motion to Strike, Approving Settlement Approving Discontinuance, Approving Transfer of Certificates, and Terminating Docket,* Docket No. SPU-96-3, State of Iowa, Department of Commerce, Utilities Board, May 30, 1996.

[25] See *Reply Affidavit of Lee L. Selwyn and Patricia D. Kravin,* note 8, supra.

failed to anticipate more competitive local-exchange markets over the economic life of the plant and equipment.[26]

Finally, the suggestion that few of the costs considered in TSLRIC are sunk may at first seem at variance with the argument that there are significant entry barriers in local-exchange services. After all, if there are no sunk costs, then shouldn't the markets be contestable? The answer to this is no, and the apparent confusion stems from confusing TSLRIC with the cost standard which would be used by an incumbent monopolist formulating entry-deterring pricing strategies. For a monopolist ILEC anticipating a price war, the horizon is much shorter than for the decision to enter, exit, or invest in additional network capacity. Within this shorter "price war" horizon, many of the ILEC's costs will be properly construed as unavoidable and hence sunk. This assessment of the ILEC's strategic options (in the absence of regulatory controls) would be known to both the ILEC and the entrant. The entrant, however, would face a significant asymmetry of information (leading to a higher discount rate) and greater

---

[26] See *Reply Affidavit of Lee L. Selwyn and Patricia D. Kravtin,* note 8, supra. Two other conclusions of the study by Selwyn and Kravtin (quoted from pages 3 and 4) undermine Hausman's argument:

- ILEC efforts to expand the market for additional residential lines and other discretionary services required the ILECs to design and construct for more extensive feeder and distribution infrastructure (and expand far greater aggregate capital investments) than otherwise would have been required to provision basic local-exchange service and appear to overwhelm simple growth in basic local exchange line demand as a principal investment driver.
- ILEC strategic positioning in the market for advanced and broadband digital services has resulted in the ILECs significantly increasing feeder facilities relative to those actually required to meet demand for basic local-exchange lines and other POTS services, and provides a far better explanation of capacity expansion than simple POTS demand growth.

demand uncertainty. Also, the entrant will need to invest in significant one-time retail-related expenses which are not an issue for the ILEC, and in any case, would be excluded from the computation of the TSLRICs for unbundled network elements. This fundamental asymmetry implies that the entrant would perceive entry (followed by a potentially prolonged price war with the ILEC) as involving high sunk costs (over the duration of the price war) and could be effectively deterred from entering.

IV. Implications for Regulatory Policy Toward Capital Recovery

Our analysis demonstrates that Professor Hausman's strong claims about effects of capital goods price declines and option value of delay on the user cost of capital and efficient prices are overstated. Conventional derivations of the user cost of capital already treat the former through accelerated depreciation, not higher capital recovery allowances in all future periods. While Hausman's option value arguments have merit in the example (unrelated to telecommunications) that he poses, they do not imply the need for large increases in capital recovery parameters used to calculate TSLRIC prices.

Our analysis suggests no need to change existing procedures used in the regulatory process to determine required rates of return and the user cost of capital. Indeed, in offering guidance to state regulatory commissions, the Commission can suggest that state commission staff turn to financial markets for analytical rigor. As suggested by the logic of the CAPM described earlier, to the extent that the transition to competition raises the nondiversifiable risk borne by LECs' shareholders,

the required rate of return on LECs' equity rises.[27] However, Wall Street telecommunications analysts will subsume the effects described by Hausman in their expectations of and discounting of and LECs' future earnings. Estimates by these analysts form the basis for discounted cash flow estimates of the cost of equity capital that have typically been relied on by Commissions.[28] Thus, current Commission practices already address Professor Hausman's substantive concerns.

---

[27] Because the literature on option values in investment decisions is relatively new, there is little empirical evidence to suggest that required rates of return incorporating option values differ significantly from required rates of return predicted by the CAPM. Indeed, Vivek Ghosal and Prakash Loungani find little effect of price uncertainty on industry investment except for industries with almost no concentration. Ricardo Caballero and Robert Pindyck estimate for U.S. industries generally "that a doubling of industry-wide uncertainty raises the required rate of return on new capital by about 20 percent." See Vivek Ghosal and Prakash Loungani, "Product Market Competition and the Impact of Price Uncertainty on Investment: Some Evidence from U.S. Manaufacturing Industries." *Journal of Industrial Economics* (June 1996), pages 217-228: and Ricardo Caballero and Robert S. Pindyck, "Uncertainty, Investment, and Industry Evolution," Discussion Paper, Massachusetts Institute of Technology, September 1995.

[28] See the Commission's *Order* on CC Docket No. 89-624, or Appendix D of AT&T's *Comments* in CC Docket No. 94-1, filed May 9, 1994 for a brief description of how a discounted cash flow calculation is performed for the LECs.

Depreciation and Capital Recovery Issues

A Response to Professor Hausman

Kenneth C. Baseman
Frederick R. Warren-Boulton
Susan E. Woodward

July 24, 1996

MICRA
1155 Connecticut Ave., NW
Suite 900
Washington, DC 20036

Prepared on behalf of MCI.

I. INTRODUCTION

In his May 30 Affidavit to the Commission Jerry Hausman raises two issues concerning appropriate capital recovery costs incorporated into TSLRIC-based rates for unbundled elements of local telephone service.[1] He argues that (1) TSLRIC studies are inherently incapable of correctly dealing with depreciation when the price of capital goods is expected to fall over time,[2] and (2) there is a substantial option value that ought to be, but is not, included in the capital recovery component of TSLRIC costs.

Regarding the depreciation issue, we conclude that Hausman is simply wrong in his claim that TSLRIC can accommodate nothing but straight-line depreciation. When all reasonable evidence indicates that the prices of capital goods can be expected either to fall or rise, it is straightforward to use other-than-straight-line depreciation in TSLRIC capital recovery calculations. Indeed, depreciation schedules that appropriately reflect the expected trends in the price of capital goods can produce higher prices in some settings, and lower ones in others, but in all cases prices that more accurately reflect true scarcity.

Regarding the treatment of options and their value in determining appropriate capital recovery prices, we find Hausman's discussion neither informative nor helpful. We readily recognize that the ILECs do, when they make any

---

[1] See *Reply Affidavit of Jerry A. Hausman*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98.

[2] Hausman asserts that ". . . a TSLRIC calculation . . . assumes that the price of capital goods does not change over time." *Ibid.*, p. 4.

investment, create options for their customers. But this is true whether the CLECs are among their customers or they have only their traditional customers. Once this is acknowledged, there is no reason to alter the CAPM-based cost of capital estimates that are currently used. If these models previously produced satisfactory capital recovery for the ILECs, they still should. Only in limited circumstances, which we discuss, may any adjustment be warranted

II. DEPRECIATION

TSLRIC studies can incorporate other-than-straight-line depreciation in a straightforward way. Thus Hausman's criticisms of TSLRIC raise empirical questions, but do not, as he asserts, present ›damental problems with TSLRIC methods. If the prices . ‹ capital goods are expected to change, it is a mistake to require that straight-line depreciation be incorporated into the regulated output prices. Hausman correctly notes this. He is in error, however, when he claims that an expected decline in the price of capital goods would require that depreciation expense be higher in all years. For a given expected useful life, accelerating depreciation entails higher depreciation charges in the early years of an asset's life, but lower ones in the later years. If [*2*] falling prices for capital goods are incorporated into TSLRIC, the resulting price schedule will reflect higher depreciation expense in the early years, and result in higher user prices, and lower depreciation expense and user prices in the later years.[3] The asset lives

[3] For a theoretical treatment of the necessity for accelerated (or front-loaded) depreciation when capital goods prices are declining, see Crew and Kleindorfer, "Economic Depreciation and the Regulated Firm under Competition and Technological Change." *Journal of Regulatory Economics*, vol. 4, March 1992.

themselves are subject to little dispute; there is evidence that the difference between regulators' and LECs' estimates of useful assets' life is quite small, and that most of the differences occur in subscriber metallic cable, not in other asset classes such as switches.[4]

We accept the proposition that if prices of capital goods are expected to decline, then accelerated depreciation is called for. However, there are several reasons to believe that the adjustments to TSLRIC costs, if any, will be small. First, Hausman provides no evidence that the prices of capital goods purchased by the ILECs are expected to decline in the future. His numerical examples apply recent switch price decreases to all telephone plant, even though he presents no evidence on past or expected future price trends for other capital goods. In addition, some knowledgeable observers predict that switch prices will decline very modestly over the next five years or so.[5] Second, any claims from the ILECs concerning future capital goods price declines should be consistent with those same ILECs' productivity projections for price caps.[6] Third, Hatfield's TSLRIC cost estimates are not particularly sensitive to changes in the cost of capital goods, so average costs over a multi-year period should not be very sensitive to shifts of

[4] See Baseman & Van Gieson, "Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by the Local Exchange Carriers." MICRA Research Report, December 1995.

[5] *The U.S. Central Office Equipment Market*, Northern Business Information, January 1996.

[6] It is not immediately obvious how USTA will reconcile Hausman's projection of enormous expected future price declines for all capital purchased by ILECs with USTA's recent positions in price cap proceedings that future productivity growth for the LECs will be very moderate.

depreciation expense across years.

Regulators may be inclined to revisit depreciation policy on "fairness" grounds. If switch price depreciation has been too low in the past, they may feel that some compensation is called for. If the Commission and state regulators decide to revisit depreciation policy, they should do a complete job, and not limit their inquiry to adjustments that provide a financial benefit to the LECs. Other aspects of depreciation deserve attention. In particular, conventional straight-line depreciation produced cross-subsidies from monopolized to competitive services. We have in [*3*] mind especially assets that were put in place ahead of expected use. We do not dispute that such investments may have been efficient. To the extent the equipment in telephony comes in lumpy increments, it is efficient to invest early, live with underutilization for a while and, in doing so, realize the benefits of scale economics (lay more cable than is presently needed while the ditch is open). But then to apply straight-line depreciation as soon as the asset is placed in use is not appropriate and results in prices that are inefficiently too high in the earliest years of the asset's life. Here the pattern of depreciation to be included in regulated product prices is one which starts low, then rises, and then falls, reflecting increasing use in the early years, and declining capital prices in the later years. To fail to have prices correctly reflect usage results in today's customers partially paying for capacity put in place to serve tomorrow's customers.

In the old regime of regulated local telephony, especially given the substantial overlap in the identity of today's and tomorrow's customers, these cross subsidies resulted in little distortion. However, the approach allows cross subsidies that are potentially distortionary in the new regime. It makes sense that the LECs will want to have capacity in place, and be ready

to serve the long-distance market as soon as they have the freedom to do so. However, the costs of that capacity should be paid for entirely from the LECs *future* long-distance revenues.[7] Current regulatory practice fails to require that separation. Indeed, since the switching and transport investments can also be used for local and intra-LATA services, current customers of those services are now paying the depreciation expenses for capacity put in place to serve the future long-distance market.[8] For (forward-looking) efficiency, the costs of such capacity should be excluded from the costs of unbundled elements for local service (as happens in Hatfield's TSLRIC study which sizes the network to provide only local, narrowband services). For (backward-looking) fairness, it is likely that local service customers are entitled to refunds to reverse their past contributions to this cross-subsidy.[9]

III. OPTION VALUES AND TSLRIC

Hausman's most intense criticism is directed at the DOJ and IXCs for their alleged failure [*4*]to understand the importance of option value in investment decisions. When

---

[7] The same argument applies to other potential cross-subsidies, such building broadband plant before there are revenues from video or other broadband services, yet charging depreciation expense to the cost of basic local services.

[8] Selwyn and Kratvin have provided evidence suggesting that this cross-subsidy concern is a very real one. The LECs' rate of investment in new equipment has far outstripped the growth in demand for services they are now allowed to offer. See Lee Selwyn and Patricia Kratvin, *Analysis of Incumbent LEC Embedded Investment, Economics and Technology, Inc.*, filed with AT&T Reply Comments in CC Docket No. 96-98, May 30, 1996.

[9] Prices are not subsidy-free if a group of customers pay more for service than the TSLRIC of a network designed to serve only that group.

investments are irreversible (i.e., costs are sunk), the act of investing extinguishes the option of waiting and investing (or not) later. This option has value, and the return to investment should include the value of the now-foregone option to wait.[10] Hausman emphasizes that investment on the part of the ILECs, together with the new legislation, give the CLECs the *option*, but not the *obligation*, to use the investments the ILECs have made.[11] Hausman argues that the CLECs should be required to pay the ILEC a premium in excess of TSLRIC to compensate

---

[10] For discussions of the "investments as options" literature, see Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty*, Princeton University Press (1994) and R. Glenn Hubbard, "Investment Under Uncertainty; Keeping One's Options Open," *Journal of Economic Literature*, December 1994, pp. 1816-1831.

This literature emphasizes the role of one-way bets in some investment decisions. That is, in certain circumstances an investment's upside is more limited that its downside, and the investor rationally requires a premium to undertake the investment (and extinguish the option not to invest). The literature includes full models of the "monopoly" case, where only one firm has the option of making the investment, and the "competitive" case, where many firms can invest and each knows that if it does not invest, other firms may. The one-way bet in the monopoly case arises from waiting for better information while deferring the investment. If later information shows the investment to be a good one, it can still be made. So the costs of waiting are low. However, if the new information shows the investment to be a bad one, an expensive mistake has been avoided. In the competitive case, the asymmetry is said to arise because if uncertainty is resolved against the investment, the firms having made it suffer losses (since the investment is irreversible). If uncertainty is resolved in favor of an investment, incumbents expand and new entry occurs, which puts a limit on the profits to be realized.

This literature does not include complete models of oligopoly situations, where there may be advantages to moving first. Dixit and Pindyck recognize that such first-mover advantages might reverse the analysis, creating an advantage to investing early.

[11] Hausman, *op cit.*, p. 2.

the ILEC for bearing the risk associated with the new investment over its full economic life.

We agree that investment by the ILECs gives the CLECs options. But we would also argue that the ILECs have always given their customers exactly these options. The ILECs' traditional telephone customers made no long-term commitments to the ILECs. They have always had the option, but not the obligation, to have telephone service, and the right to disconnect their phones or reduce usage. Thus, if the prior TSLRIC calculations resulted in adequate capital recovery to ILEC investors, they need not be altered. Indeed, all business enterprises give their customers options. The local supermarket, for example, gives customers the option to buy all sorts of perishable food. Some of these options expire worthless; that is, they spoil or are discarded. Investments are made, not knowing whether or how much customers will buy. On average, returns to these investments cover costs, including the costs of options the customers do not exercise. Telephone services are not different.

[*5*] This perspective informs a deeper understanding of exactly what "option value" issues arise with the entry of the CLECs into local telephone service. If the choice is for the ILEC to lease capital to a CLEC or to use that capital to serve local customers directly, the only factor that could justify altering the TSLRIC price to the CLEC is its greater willingness to commit to a long-term contract. In this case, of course, the price should be adjusted *down*, not up, because any failure for the CLEC's customers to fully utilize the capacity that the CLEC has leased is the CLEC's problem, not the ILEC's. In other words, the CLEC has assumed the risk associated with the option from the ILEC and the ILEC now

need no longer charge for it.[12]

The situation in which a substantial *ex ante* adjustment to the TSLRIC prices for future investments[13] might be in order is limited to circumstances where, as a result of leasing equipment

---

[12] A customer making a term commitment thus has earned a discount (below a Hatfield TSLRIC) because it is bearing risks that the ILEC was paid to bear in the circumstance where customers did not make term commitments.

It is easy to see why customer commitments shift risk from seller to buyer. Suppose in a world with no commitments, a local recession reduced demand by 10%. Then (with binding price caps), the ILEC's revenues fall 10%. However, if 20% of the customers' volume entailed term commitments, then in the same local recession, the ILEC loses 10% of revenues on the uncommitted volume, but suffers no losses on the committed volume, resulting in a revenue loss of less than 10%.

CLECs should also receive additional discounts if the capacity rights they commit to are less valuable than the capacity rights retained by the ILEC. An example is where the ILEC retains the right to use capacity committed to the CLEC in the event the CLEC is not using it, but the CLEC does not obtain a similar right to access unused ILEC capacity. To see how this could work, suppose a CLEC has rented rights to 20% of a switch's capacity. If the ILEC retains the right to use more than 80% of the switch's capacity in the event the CLEC is not using it, the ILEC has "use it or lose it" rights with respect to that capacity. If the CLEC does not have similar rights to unused ILEC capacity in the switch, then discounted terms should govern the price paid by the CLEC for capacity rights, since those rights are less valuable than the capacity rights retained by the ILEC. The ILEC benefits from asymmetric "use or lose" provisions because the capacity costs to serve its own demand fall. That is because, to the extent that the ILEC is able to sometimes serve its customers with capacity that others have paid for, the ILEC's ratio of own capacity to output is reduced.

[13] We wish to stress that here we are dealing with the criticisms Hausman levels against TSLRIC pricing principles for future investments. We are not addressing the stranded cost issues associated with the ILECs' embedded plant. We disagree with Hausman on that issue as well, but that is not the subject of this paper.

to the CLEC, the ILEC experiences a decline in capacity utilization that otherwise would not have occurred. For example, the classic complaint of the LECs is that it is the intent of the CLECs to lease equipment from them for a few years, steal their customers, and then build their own [*6*] equipment, leaving the LECs with unused, and presumably unpaid for, capacity.[14]

While we cannot rule out such a scenario, we believe it is reasonable to ask: Why would the CLECs ever build their own equipment if the ILECs could do it cheaper? Perhaps because the ILECs are not cooperating with them? Is it reasonable to allow the ILECs to charge the CLECs more to lease the ILECs' equipment because their own uncooperative behavior is going to drive the CLECs *to build their own equipment*? It seems that to allow this would only increase the likelihood of cooperation failure. By charging the CLECs higher prices to start, the ILECs give them further incentives to build their own equipment, which makes the ILECs all the more eager to collect whatever they can from the CLECs, while they can. "Solving" the possible problem of redundant capacity by raising the price on rented capacity would thus be truly perverse.

---

[14] The potential problem of redundant capacity can be ameliorated by treating TSLRIC prices as a schedule of *maximum* prices. If an ILEC's short run incremental cost is less than TSLRIC (as may occur if the ILEC has excess capacity), then society, the ILEC and the CLECs are all better off with a uniform price for unbundled elements set below TSLRIC. Society, the ILEC and the CLECs share an interest in avoiding redundant capacity. At a price for unbundled elements less than TSLRIC, society benefits because redundant capacity is not built, the ILEC benefits because some margin over short run incremental cost is better than no revenues and stranded investment, and the CLECs benefit because (at least until the ILEC no longer has excess capacity), they receive prices below the costs (TSLRIC) at which they could build their own facilities.

There are more reasonable ways to address the issue. Under what conditions would an ILEC's TSLRIC costs associated with a current investment (the "facility") be increased as the result of input sales to competitors? The necessary conditions include

1) more customers end up being served in the future by facilities owned by someone else than if the input sales were not made,

2) the ILEC's future expected capacity utilization for the facility unavoidably falls as a result, and

3) the ILEC's average cost for the facility increases due to the fall in capacity utilization.

As long as the CLEC continues to use the ILEC's facilities, of course, any capture of customers by the CLEC or customer switching between the ILEC and the CLEC, will not affect the demand for, or capacity utilization of, the ILEC's facilities. Thus the first condition rules out any effects from resold local service, as well as any effect from the sale of unbundled elements so long as the ILEC's facilities are used.

With respect to the second condition, it might seem self-evident that the construction of facilities by a CLEC to serve its local customers would always reduce the rate of capacity utilization of the ILEC's facilities. But it is not so simple. In some plausible situations, the defection of ILEC customers in the future to the CLECs will increase the ILEC's capacity utilization (and reduce the ILEC's costs). The CLEC's decision to build its own capacity in the [*7*] future will reduce the need for the ILEC to build capacity. As a result, the ILEC's expectation of future lost sales to other CLECs reduces

its expected rate of growth. Since telecommunications capacity is often added in lumpy increments, capacity utilization over time can be a decreasing function of the rate of growth.[15] In that case, if the ILEC's growth rate slows (but does not turn negative), its average cost is in fact reduced by the future loss of sales to the CLECs. The ILEC can defer investment that, if made, would cause it to enter the high cost, high excess capacity portion of the capacity cycle.

The third condition is not met if the ILEC can quickly resize its facilities at low cost.[16] The second and third conditions jointly are not met if the contract provisions with the CLEC combine sufficient term length and/or termination notice to allow the ILEC to revise its facilities plan at low cost to take

---

[15] Consider a simple example. Assume no scale economies. If capacity is most efficiently added in discrete increments then an ILEC facing zero demand growth achieves minimum cost *for it never has to carry the costs of excess capacity for future growth*. Similarly, an ILEC facing low demand growth can achieve lower costs than an ILEC facing high growth, for the low growth ILEC never has to carry much excess capacity, and can achieve costs almost as low as the zero growth company.

Now we are not suggesting that low growth ILECs will always have lower costs than high growth ILECs. There are cases where high growth generates lower costs. However, we are warning that the intuitive view that lower capacity utilization will always be the result of CLECs' expansion is not a valid generalization.

[16] It may well be that the physical elements of the ILEC's networks that the CLECs are most likely to replace with their own facilities (switches) are, because of modern modular designs, also the network components that are easiest for the ILEC's to reconfigure at low cost; while the network elements with the least short term cost flexibility for the ILEC's (distribution loop) are the elements where the CLECs are most likely to rely on the ILEC's facilities for a long time.

into account the changed requirements.[17] Indeed, when the ILEC's capital recovery would be too low at TSLRIC-based spot prices, the efficient answer is not only to raise the spot rental price and stop there. As already noted, this is sure-fire way to induce cooperation breakdown even when it is socially efficient for the ILEC to build the facility. Rather, term commitments and/or termination notice provisions are the efficient solution. And, also as already noted, customers making adequate commitments would pay less than TSLRIC because they are bearing risks for which the ILEC would otherwise be compensated in a [*8*] competitive context (via the risk-adjusted rate of return).[18] These topics are revisited in the final section of this paper.

With respect to the cost of capital issue, the realization that virtually all businesses give their customers options is especially helpful. In particular, it suggests that if businesses have successfully compensated investors in the past, we need

---

[17] In a steadily growing market, such as local telephony, it is far easier to accommodate at low cost changes in future requirements based on the decisions of individual customers to take their business elsewhere. So long as the lost business is less than expected growth, the seller can simply forego investments in additional capacity it otherwise would have made.

[18] Consider a competitive market. When a customer's demand is large relative to the seller's capacity, the seller faces the need to build new capacity to meet the customer's requirements. If the investment is long-lived and irreversible, and the buyer does not agree to term commitments and/or adequate termination notice to allow the seller to adjust its facilities requirements, then the customer will pay a high price (above TSLRIC) or the seller will not build the facility. However, when the customer commits to an adequate contact length and/or offers adequate notice of termination, the price will be low (below TSLRIC) because the buyer is now bearing risks that a seller would ordinarily bear and receive compensation for in a risk-adjusted rate of return.

not now think that the cost of capital is higher than we previously believed. Indeed, work on the CAPM has long noted that firms in industries that involve large sunk costs and irreversible investments tend to have higher betas, and therefore higher costs of capital.[19]

Hausman, however, would have us believe that not only should an option value be incorporated into TSLRIC, but that a "TSLRIC calculation which ignores the sunk cost feature of telecommunications network investments would thus be off by a factor of two." Hausman's ruminations on this issue are particularly misleading. The flaws deserve some attention.

The "factor of two" claim is based on a numerical example that Hausman burrowed from Dixit and Pindyck. The numerical example was constructed to be extreme in order to demonstrate option value to students. The example is not relevant to the policy issues at hand. First, it was based on complete monopoly, where only one firm could make the investment decision, whereas the situation we address here is one in which numerous firms could make the investment. Second, the example involved only fixed costs, and no variable costs at all and, thus, overstates any option value. Third, the example involved arbitrarily chosen parameter values of no relevance to telephone companies or their regulators.

Hausman's claim that corporate hurdle rates generally include a substantial option premium is not correct.[20] Moreover, why he believes this apparently involves a shocking

---

[19] See Brealey and Myers, *Principles of Corporate Finance*, McGraw-Hill (1988), pp. 190-1.

[20] See Hausman, *op cit.* at p. 7.

error on his part. His claim comes from a study by Summers, who surveyed CFOs of large U.S. corporations and asked them to report the after-tax *nominal* hurdle rates they used in investment [*9*]decisions.[21] They reported a mean rate of 17%, with a modal rate of 15%. Hausman claims that these rates far exceed the cost of capital.

But they do not. The CAPM cost of capital for a company of average risk (beta equals one) is just the risk-free rate plus the equity premium. The *real* riskless rate has averaged 1.0% over the last sixty years. The equity risk premium for large companies such as those surveyed by Summers has averaged 7.4%, for a total average real return of 8.4%.[22] To compare these *real* (net of inflation) figures to Summers' *nominal* (gross of inflation) ones, we must subtract expected inflation from the nominal rates. To estimate expected inflation, we look to the ten-year government bond rate at the time of the study (1985), which was 10.62%.[23] The average real return on such bonds has been about 2%, which implies expected inflation of 8.6%.[24] Subtracting 8.6% from Summers' mean nominal hurdle rate of 17% gives a real hurdle rate of 8.4%, *identical to the CAPM cost of capital*. There is no mystery to be explained by an options premium. The only mystery is how Hausman confused

---

[21] See Lawrence Summers, "Investment Incentives and the Discounting of Depreciation Allowances," in *The Effects of Taxation on Capital Accumulation*, Martin Feldstein, Ed. (Chicago), University of Chicago Press, 1987.

[22] See Ibbotson Associates, *Stocks Bonds Bills and Inflation*, 1995 Yearbook, Table B-1 at p. 157.

[23] *Economic Report of the President*, 1993. Table B-69 at p. 248.

[24] Ibbotson Associates, *Ibid.*, Table 6-6 at p. 118.

nominal and real rates of return.[25]

[*10*]

IV. MORE ON ONE-WAY BETS

Hausman asserts that proponents of TSLRIC are trying to impose an unfair, one-way bet on the ILECs. He argues (p. 2) that the ILECs are compelled to invest using today's technology, yet the CLECs can wait without risk, buy unbundled elements at TSLRIC from ILEC and, if quality-adjusted equipment prices fall, the CLECs can invest in the future using the newer, cheaper technology, or simply

---

[25] The options literature is fairly new, and there does not yet appear to be any consensus on its significance for estimating firms' costs of capital. The literature, however, does include an empirical attempt by Pindyck and another co-author to estimate the increase in the cost of capital (or the capital recovery factor) necessitated *in the multi-firm context*, by the options value created by irreversibility and uncertainty. In U.S. industries generally, Caballero and Pindyck "find that a doubling of industry-wide uncertainty raises the required rate of return on new capital by about 20 percent." (See Caballero and Pindyck, "Uncertainty, Investment, and Industry Evolution," Discussion Paper, MIT and NBER, September 1995.) It is not clear the extent to which these results are inconsistent with conventional CAPM estimated costs of capital for their sample. However, because betas are sensitive to sunk costs, we would expect CAPM costs of capital estimated on the same sample to show a similar pattern.

Another paper finds that price uncertainty does not affect investment in any but the most unconcentrated market. When the four-firm concentration ratio exceeds 20%, the effect of price uncertainty is "always small and not significantly different from zero." The authors' conjecture that, as Dixit and Pindyck argue, the option value to waiting is important in structurally competitive industries, but due to strategic issues and first-mover advantages, the theory does not hold up in even modestly concentrated industries. See Ghosal and Loungani, "Product Market Competition and the Impact of Price Uncertainty on Investment: some Evidence from US Manufacturing Industries," *The Journal of Industrial Economics*, June 1996, pp. 217-228.

request reductions in element prices based on the new, lower TSLRICs. But Hausman merely asserts, and does not demonstrate, that this is a one-way bet. If equipment prices rise, or if costs of installing loops increase, then TSLRIC will increase, and under TSLRIC pricing, the ILECs are allowed to increase their prices for unbundled elements whenever the pricing of the elements is revisited.[26] This will provide the ILECs with an unanticipated profit, since they invested before the increases in unbundled element prices were known. In order to make the investment a fair bet for the ILECs, expected changes in the future cost of the elements should be taken into account in setting TSLRIC prices. But assuming that has been done, TSLRIC does not force a one-way bet on the ILECs, and there is no reason for an option premium.

Hausman also alleges that TSLRIC studies expose the ILECs to uncertainty over demand, but do not compensate the ILECs for assuming this risk. This allegation reflects a misunderstanding of Hatfield's TSLRIC methodology. The Hatfield model estimates an annual TSLRIC cost for the local carrier. The plant is sized to service current demands, with initial fill rates set to accommodate future growth. Thus, for a particular piece of the network, Hatfield may assume a 60% fill rate, whereas additional investment is not needed until the fill rate reaches (say) 85%. In that case, Hatfield's TSLRIC price (for the first and all subsequent periods!) is based on a 60% fill rate. In fact, with demand growth, the asset will realize higher average fill and, therefore, lower average unit costs over its lifetime. In short, with respect to demand uncertainty, Hatfield's TSLRIC methodology entails a one-way bet favoring

---

[26] MCI has proposed that the initial unbundled element prices remain in effect for three to five years. See *Comments of MCI Corporation*, CC Docket No. 96-98, May 16, 1996 at p. 68.

the ILEC. The ILEC captures the cost savings from increased utilization in future periods, but does not share those savings in reduced TSLRIC prices. The ILECs' only offsetting risk is that demand for use of its local telephone facilities may actually fall; (i.e., market demand growth will be less than the loss of sales to facilities-based local competitors.) This risk seems very low given the rapid growth in demand for local service, which flows from population growth, increased long distance traffic, and the increase in multiple lines to accommodate increasing use of Internet and on-line services.

[*11*]

V. CONCLUDING COMMENTS

We have demonstrated that Hausman's depreciation and option value arguments contribute little to our understanding of appropriate policy in the telecommunications arena.

With respect to depreciation of capital goods, it is clear that if capital good prices are expected to fall, accelerated depreciation is in order. Accelerated depreciation by itself does not change the useful life of equipment and, thus, depreciation will not be higher in all years, as Hausman erroneously claims, but only in the earlier years. Although it is an empirical question the magnitude of any such changes to TSLRIC pricing will likely be small.

The option valuation arguments are more subtle. We agree options are important. But we also realize that producers investing in long-lived capital have always given their customers particularly valuable options, and do not regard the new situation as substantially different. Nor do we regard it appropriate for the ILECs to be able to charge their CLEC customers for anticipated cooperation breakdown, when the party whose cooperation is most needed is that of the ILEC

itself.

With respect to the cost of capital, we find no evidence that the CAPM has failed to properly compensate investors for option values. It is rather like the Bourgeois Gentilhomme who discovers that be has been speaking prose *all of his life*. So has the CAPM been adjusting the cost of capital to compensate investors for options given to customers. Hausman provides no empirical evidence that the "options" view of investment should change our views on the cost of capital (as opposed to improving our understanding of why the cost of capital is higher for some firms that for others), and we demonstrated that his main piece of evidence for high option values (his interpretation of Summer's research) reflected a surprising confusion over real versus nominal rates of return. Adjustments to the cost of capital are in order in only two circumstances. First, if the CLEC is willing to commit for services on more than a spot market basis, that is, to buy the option from the ILEC and give it to customers itself, price should be lower, reflecting that the ILEC no longer bears this risk. Second, if doing business with the CLEC is likely to result in lower capacity utilization for the ILEC, then price should be adjusted up. But in this case, we must ask why capacity utilization will be affected and be certain that the appropriate price or other contractual adjustment does not worsen incentives to cooperate.

We have demonstrated that Hausman provides no empirical or theoretical basis for his proposed massive increases in capital recovery for TSLRIC prices. Nonetheless, the costs of network elements will be at least partially sunk, and we do not argue that this fact should be ignored. In any event, a modest increase in LEC hurdle rates above the pre-1996 cost of capital may be warranted simply on traditional CAPM

grounds: a move from a sheltered monopoly environment to a more competitive environment exposes the shareholders of the firm to increased nondiversifiable risk. Risks that used to be borne by ratepayers are now (or should be) borne by shareholders. In that regard, it is worth noting that the costs of capital in the Hatfield model are in fact considerably higher than the costs of capital LEC's have been allowed to earn historically. [*12*] That is because LEC allowed rates of return are *nominal* rates of return (typically in the 9-11% range[27]), whereas Hatfield's cost of capital (around 10% with variations across LECs) is a *real* cost of capital,[28] and is therefore equivalent to a 13-14% *nominal* cost of capital. Thus, Hatfield's cost of capital is already 30-50% higher than rates of return typically allowed by state regulators.

Building an option value into the capital recovery factor implies that the seller (the ILEC), bears all the risk and is compensated with a higher monthly rental price for its facilities.[29] At the other extreme, the buyer could commit to pay for the capacity whether he uses it or not. In that case the

---

[27] See *Utility Regulatory Policy in the United States and Canada*, 1993-94 Compilation, National Association of Regulatory Utility Commissioners, Table 120 at p. 292.

[28] Hatfield's model selects a uniform, multiperiod price, with no adjustments for either changes in the purchasing power of money (general inflation would reduced the value of future revenues) or for changes in future variable input prices.

[29] If market prices are constrained to the level of the marginal costs of new entrants who obtain elements at TSLRIC-based prices from the ILEC, then it is very important not to overestimate those TSLRIC-based costs. If the ILEC has a 90% market share, and the entrants have a 10% share, a small overcharge in TSLRIC prices to the entrant results in overcharges to the entire market, and not just to the 10% of the market served by entrants.

seller deserves no option premium (indeed, customers making commitments are entitled to discounts relative to customers who do not commit) because the buyer is bearing the entire cost of uncertainty. Real-world competitive markets exhibit a wide variety of risk sharing via contract between these two extremes. The appropriate degree of risk sharing need not ordinarily be imposed by an outsider in the ordinary commercial context, where the buyer and seller have a joint interest in consummating the transaction. Reliance on purely private agreement is not likely to work here, however, because the ILEC has no incentive to reach agreement. Thus, while it is not unreasonable that customers bear some of the risks associated with long-lived investment provide unbundled elements, left to their own devices the LECs' optimal strategy is to hold out for contract terms so onerous that the demand for unbundled elements is kept to the minimum necessary for the LEC to be allowed to enter long distance service. The solution, perhaps, is to examine otherwise similar situations where the LEC had an ordinary commercial motivation to reach an agreement with a customer, and pattern up-front payments, contract lengths and cancellation penalties for the CLECs on the terms and penalties in similar contracts.[30] For [*13*]example, the offering of

[30] Another possibility is to require the CLEC to sign a long term lease covering the useful lives of the assets it wants to rent. They could resell those rights later, but they, not the ILEC would then suffer any resale loss. The problem is that the market for resold capacity may be a very thin one, and one where the ILEC possesses monopsony power. It seems likely that the ILEC will often have the highest value on facilities abandoned by a CLEC whose entry attempt failed, since the ILEC will have a network covering the entire region, whereas other CLECs, if there are any, may have networks located or designed in such a way that the abandoned capacity is of low value to them. In that case, the ILEC will win the bidding for the capacity at prices below the value of the capacity to the ILEC. It is by now well accepted that exit barriers are entry barriers. Here, the exit barrier is the likelihood that a CLEC will not receive fair market value for its abandoned investment. As a result, the prospects for socially beneficial entry will be reduced if CLECs had to commit to rent services over an asset's entire useful life.

CENTREX entailed major facilities investments by the LECs in switching, transport, and loop capacity (i.e., facilities of the type the CLECs will need). The LECs invested in these facilities in advance of contracts with customers, so that they could market CENTREX as a service available to new customers on short notice. Similarly, CENTREX customers could decide later, after the facilities are in place, that they want to convert to PBXs, much as IXCs may decide later to build their own facilities and no longer use the capacity they had rented from the LEC. Thus the required up-front payments, contract duration, cancellation penalties and other terms in CENTREX contracts would appear to be useful benchmarks for reasonable terms and conditions associated with the ILECs' provision of facilities to the CLECs.[31]

KENNETH C. BASEMAN

Kenneth C. Baseman is a principal at MICRA. He was with the Antitrust Division of the U.S. Department of Justice for eight years and has spent thirteen years as a private economic consultant, focusing largely on antitrust and the economics of regulation. He

[31] If in fact other ratepayers have been protected from cross-subsidy by the terms and conditions of CENTREX contracts, then the ILECs cannot credibly claim that they need greater term commitments than those found in the CENTREX contracts when they sell unbundled elements to CLECs. Nor can they credibly claim that capital recovery factors need to be doubled or trebled (a la Hausman) over the LECs' historic levels before the sale of unbundled elements to the CLECs will be compensatory. Clearly CENTREX investment was sunk, and the LECs faced uncertainty about future demand and technology, so that if it was not appropriate to include an extraordinarily high option value in CENTREX rates, it is also not appropriate to do so now for unbundled elements sold to the CLECs.

has a broad background in several industries, including telecommunications, broadcast and cable television, and electric utilities.

Mr. Baseman has submitted written testimony on numerous occasions to regulatory authorities on issues such as the costs and benefits of line-of-business restrictions for profit-regulated monopolists; the effects of alternatives to traditional rate-of-return regulation; the effects on consumers of cable deregulation; economic and competitive issues relevant to expanded interconnection by local telephone companies with emerging sources of competition; and the implications for the exercise of market power of abandonment proposals for natural gas pipelines at the FERC. He has considerable experience, from various antitrust matters, with the competitive and efficiency aspects of joint venture operations and long-term contracts.

Mr. Baseman received his graduate training in economics at Stanford University, where he received an MA. His publications include articles in the economics of open entry and competitive in natural monopoly contexts.

FREDERICK R. WARREN-BOULTON

Frederick R. Warren-Boulton is a principal at MICRA. He has over twenty years of academic, government and private sector experience in antitrust and regulation. He has testified and published extensively in those areas and on the issue of corporate governance. He is an internationally recognized expert in the economics of vertical restraints.

From 1983 to 1989, Dr. Warren-Boulton served as the chief economist for the Antitrust Division of the U.S. Department of Justice, first as Director of its Economic Policy Office and then as the first Deputy Assistant Attorney General for Economic Analysis. Dr. Warren-Boulton contributed to the economic analysis of general policy issues, as reflected in the 1984 Merger Guidelines, the *Vertical Restraint Guidelines* and the antitrust provisions of the

Sentencing Guidelines, as well as legislative initiatives on issues such as resale price maintenance, revisions of the antitrust statutes and deregulation of oil pipelines.

Dr. Warren-Boulton has held faculty positions in economics or psychology at Washington University, Princeton and The American University. He holds a B.A. from Yale University and M.P.A., M.A. and Ph.D. degrees from Princeton University.

SUSAN E. WOODWARD

Susan E. Woodward is a consultant to MICRA. Her primary expertise is financial economics. Dr. Woodward was chief economist at the Securities and Exchange Commission from 1992 to 1995, where she worked on SEC enforcement matters and on regulatory issues in corporate finance, stock market regulation, and mutual funds. At the U.S. Department of Housing and Urban Development, from 1987-92, she was Deputy Assistant Secretary and chief economist. From 1985 to 1987, she was senior staff economist for financial markets and institutions at the Council of Economic Advisors, where she worked on a variety of issues including corporate governance, pension policy, bank and thrift regulation, and federal credit programs.

Prior to her government service, Dr. Woodward held faculty positions at UCLA, UC Santa Barbara, and the University of Rochester, where she taught corporate finance, investments, and price theory. She has served as an expert on numerous securities fraud and related matters, and testified in tax court for the Internal Revenue Service. She holds a BA and a PhD from UCLA. She has written and published on a variety of topics in financial economics.

FROM *IN RE IMPLEMENTATION OF THE LOCAL COMPETITION PROVISIONS IN THE TELECOMMUNICATIONS ACT OF 1996*, FIRST REPORT AND ORDER, CC DOCKET NO. 96-98 (AUG. 8, 1996):

¶¶ 1 - 15

I. INTRODUCTION, OVERVIEW, AND EXECUTIVE SUMMARY

A. The Telecommunications Act of 1996 - A New Direction

1. The Telecommunications Act of 1996[1] fundamentally changes telecommunications regulation. In the old regulatory regime government encouraged monopolies. In the new regulatory regime, we and the states remove the outdated barriers that protect monopolies from competition and affirmatively promote efficient competition using tools forged by Congress. Historically, regulation of this industry has been premised on the belief that service could be provided at the lowest cost to the maximum number of consumers through a regulated monopoly network. State and federal regulators devoted their efforts over many decades to regulating the prices and practices of these monopolies and protecting them against competitive entry. The 1996 Act adopts precisely the opposite approach. Rather than shielding telephone companies from competition, the 1996 Act requires telephone companies to open their networks to competition.

---

[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, *to be codified at* 47 U.S.C. §§ 151 *et. seq*. Hereinafter, all citations to the 1996 Act will be to the 1996 Act as codified in the United States Code.

2. The 1996 Act also recasts the relationship between the FCC and state commissions responsible for regulating telecommunications services. Until now, we and our state counterparts generally have regulated the jurisdictional segments of this industry assigned to each of us by the Communications Act of 1934. The 1996 Act forges a new partnership between state and federal regulators. This arrangement is far better suited to the coming world of competition in which historical regulatory distinctions are supplanted by competitive forces. As this Order demonstrates, we have benefitted enormously from the expertise and experience that the state commissioners and their staffs have contributed to these discussions. We look forward to the continuation of that cooperative working relationship in the coming months as each of us carries out the role assigned by the 1996 Act.

3. Three principal goals established by the telephony provisions of the 1996 Act are: (1) opening the local exchange and exchange access markets to competitive entry; (2) promoting increased competition in telecommunications markets that are already open to competition, including the long distance services market; and (3) reforming our system of universal service so that universal service is preserved and advanced as the local exchange and exchange access markets move from monopoly to competition. In this rulemaking and related proceedings, we are taking the steps that will achieve the pro- competitive, deregulatory goals of the 1996 Act. The Act directs us and our state colleagues to remove not only statutory and regulatory impediments to competition, but economic and operational impediments as well. We are directed to remove these impediments to competition in all telecommunications markets, while also preserving and advancing universal service in a manner fully consistent with competition.

4. These three goals are integrally related. Indeed, the relationship between fostering competition in local telecommunications markets and promoting greater competition in the long distance market is fundamental to the 1996 Act. Competition in local exchange and exchange access markets is desirable, not only because of the social and economic benefits competition will bring to consumers of *local* services, but also because competition eventually will eliminate the ability of an incumbent local exchange carrier to use its control of bottleneck local facilities to impede free market competition. Under section 251, incumbent local exchange carriers (LECs), including the Bell Operating Companies (BOCs), are mandated to take several steps to open their networks to competition, including providing interconnection, offering access to unbundled elements of their networks, and making their retail services available at wholesale rates so that they can be resold. Under section 271, once the BOCs have taken the necessary steps, they are allowed to offer long distance service in areas where they provide local telephone service, if we find that entry meets the specific statutory requirements and is consistent with the public interest. Thus, under the 1996 Act, the opening of one of the last monopoly bottleneck strongholds in telecommunications -- the local exchange and exchange access markets -- to competition is intended to pave the way for enhanced competition in *all* telecommunications markets, by allowing all providers to enter all markets. The opening of all telecommunications markets to all providers will blur traditional industry distinctions and bring new packages of services, lower prices and increased innovation to American consumers. The world envisioned by the 1996 Act is one in which all providers will have new competitive opportunities as well as new competitive challenges.

5. The Act also recognizes, however, that universal service cannot be maintained without reform of the current subsidy

system. The current universal service system is a patchwork quilt of implicit and explicit subsidies. These subsidies are intended to promote telephone subscribership, yet they do so at the expense of deterring or distorting competition. Some policies that traditionally have been justified on universal service considerations place competitors at a disadvantage. Other universal service policies place the incumbent LECs at a competitive disadvantage. For example, LECs are required to charge interexchange carriers a Carrier Common Line charge for every minute of interstate traffic that any of their customers send or receive. This exposes LECs to competition from competitive access providers, which are not subject to this cost burden. Hence, section 254 of the Act requires the Commission, working with the states and consumer advocates through a Federal/State Joint Board, to revamp the methods by which universal service payments are collected and disbursed.[2] The present universal service system is incompatible with the statutory mandate to introduce efficient competition into local markets, because the current system distorts competition in those markets. For example, without universal service reform, facilities-based entrants would be forced to compete against monopoly providers that enjoy not only the technical, economic, and marketing advantages of incumbency, but also subsidies that are provided only to the incumbents.

B. The Competition Trilogy: Section 251, Universal Service Reform and Access Charge Reform

6. The rules that we adopt to implement the local competition provisions of the 1996 Act represent only one part of a trilogy.

---

[2] *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Notice of Proposed Rulemaking *and Order Establishing Joint Board*, FCC 96-93 (rel. Mar. 8, 1996) (*Universal Service NPRM*).

In this Report and Order, we adopt initial rules designed to accomplish the first of the goals outlined above -- opening the local exchange and exchange access markets to competition. The steps we take today are the initial measures that will enable the states and the Commission to begin to implement sections 251 and 252. Given the dynamic nature of telecommunications technology and markets, it will be necessary over time to review proactively and adjust these rules to ensure both that the statute's mandate of competition is effectuated and enforced, and that regulatory burdens are lifted as soon as competition eliminates the need for them. Efforts to review and revise these rules will be guided by the experience of states in their initial implementation efforts.

7. The second part of the trilogy is universal service reform. In early November, the Federal/State Universal Service Joint Board, including three members of this Commission, will make its recommendations to the Commission. These recommendations will serve as the cornerstone of universal service reform. The Commission will act on the Joint Board's recommendations and adopt universal service rules not later than May 8, 1997, and, we hope, even earlier. Our universal service reform order, consistent with section 254, will rework the subsidy system to guarantee affordable service to all Americans in an era in which competition will be the driving force in telecommunications. By reforming the collection and distribution of universal service funds, the states and the Commission will also ensure that the goals of affordable service and access to advanced services are met by means that enhance, rather than distort, competition. Universal service reform is vitally connected to the local competition rules we adopt today.

8. The third part of the trilogy is access charge reform. It is widely recognized that, because a competitive market drives prices to cost, a system of charges which includes non-cost based components is inherently unstable and unsustainable. It

also well-recognized that access charge reform is intensely interrelated with the local competition rules of section 251 and the reform of universal service. We will complete access reform before or concurrently with a final order on universal service.

9. Only when all parts of the trilogy are complete will the task of adjusting the regulatory framework to fully competitive markets be finished. Only when our counterparts at the state level complete implementing and supplementing these rules will the complete blueprint for competition be in place. Completion of the trilogy, coupled with the reduction in burdensome and inefficient regulation we have undertaken pursuant to other provisions of the 1996 Act, will unleash marketplace forces that will fuel economic growth. Until then, incumbents and new entrants must undergo a transition process toward fully competitive markets. We will, however, act quickly to complete the three essential rulemakings. We intend to issue a notice of proposed rulemaking in 1996 and to complete the access charge reform proceeding concurrently with the statutory deadline established for the section 254 rulemaking. This timetable will ensure that actions taken by the Joint Board in November and this Commission by not later than May1997 in the universal service reform proceeding will be coordinated with the access reform docket.

C. Economic Barriers

10. As we pointed out in our Notice of Proposed Rulemaking in this docket,[3] the removal of statutory and

---

[3] *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Notice of Proposed Rulemaking, FCC 96-182 (rel. Apr. 19, 1996), 61 Fed. Reg.

(continued...)

regulatory barriers to entry into the local exchange and exchange access markets, while a necessary precondition to competition, is not sufficient to ensure that competition will supplant monopolies. An incumbent LEC's existing infrastructure enables it to serve new customers at a much lower incremental cost than a facilities-based entrant that must install its own switches, trunking and loops to serve its customers.[4] Furthermore, absent interconnection between the incumbent LEC and the entrant, the customer of the entrant would be unable to complete calls to subscribers served by the incumbent LEC's network. Because an incumbent LEC currently serves virtually all subscribers in its local serving area,[5] an incumbent LEC has little economic incentive to assist new entrants in their efforts to secure a greater share of that market. An incumbent LEC also has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions for terminating calls from the entrant's customers to the incumbent LEC's subscribers.

11. Congress addressed these problems in the 1996 Act by mandating that the most significant economic impediments to efficient entry into the monopolized local market must be removed. The incumbent LECs have economies of density, connectivity, and scale; traditionally, these have been viewed as creating a natural monopoly. As we pointed out in our NPRM, the local competition provisions of the Act require that these

---

[3] (...continued)
18311 (Apr. 25, 1996) (NPRM).

[4] *See* NPRM at para. 6.

[5] *See* NPRM at n.13.

economies be shared with entrants. We believe they should be shared in a way that permits the incumbent LECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost- based prices.[6] Congress also recognized that the transition to competition presents special considerations in markets served by smaller telephone companies, especially in rural areas.[7] We are mindful of these considerations, and know that they will be taken into account by state commissions as well.

12. The Act contemplates three paths of entry into the local market -- the construction of new networks, the use of unbundled elements of the incumbent's network, and resale. The 1996 Act requires us to implement rules that eliminate statutory and regulatory barriers and remove economic impediments to each. We anticipate that some new entrants will follow multiple paths of entry as market conditions and access to capital permit. Some may enter by relying at first entirely on resale of the incumbent's services and then gradually deploying their own facilities. This strategy was employed successfully by MCI and Sprint in the interexchange market during the 1970's and 1980's. Others may use a combination of entry strategies simultaneously -- whether in the same geographic market or in different ones. Some competitors may use unbundled network elements in combination with their own facilities to serve densely populated sections of an incumbent LEC's service territory, while using resold services to reach customers in less densely populated areas. Still other new entrants may pursue a single entry strategy that does not vary by geographic region or over time. Section 251 neither explicitly

---

[6] *See* NPRM at paras. 10-12.

[7] 47 U.S.C. § 251(f).

nor implicitly expresses a preference for one particular entry strategy. Moreover, given the likelihood that entrants will combine or alter entry strategies over time, an attempt to indicate such a preference in our section 251 rules may have unintended and undesirable results. Rather, our obligation in this proceeding is to establish rules that will ensure that all pro-competitive entry strategies may be explored. As to success or failure, we look to the market, not to regulation, for the answer.

13. We note that an entrant, such as a cable company, that constructs its own network will not necessarily need the services or facilities of an incumbent LEC to enable its own subscribers to communicate with each other. A firm adopting this entry strategy, however, still will need an agreement with the incumbent LEC to enable the entrant's customers to place calls to and receive calls from the incumbent LEC's subscribers.[8] Sections 251(b)(5) and (c)(2) require incumbent LECs to enter into such agreements on just, reasonable, and nondiscriminatory terms and to transport and terminate traffic originating on another carrier's network under reciprocal compensation arrangements. In this item, we adopt rules for states to apply in implementing these mandates of section 251 in their arbitration of interconnection disputes, as well as their review of such arbitrated arrangements, or a BOC's statement of generally available terms. We believe that our rules will assist the states in carrying out their responsibilities under the 1996 Act, thereby furthering the Act's goals of fostering prompt, efficient, competitive entry.

14. We also note that many new entrants will not have fully constructed their local networks when they begin to offer

[8] *See infra*, Section IV.A.

service.[9] Although they may provide some of their own facilities, these new entrants will be unable to reach all of their customers without depending on the incumbent's facilities. Hence, in addition to an arrangement for terminating traffic on the incumbent LEC's network, entrants will likely need agreements that enable them to obtain wholesale prices for services they wish to sell at retail and to use at least some portions of the incumbents' facilities, such as local loops and end office switching facilities.

15. Congress recognized that, because of the incumbent LEC's incentives and superior bargaining power, its negotiations with new entrants over the terms of such agreements would be quite different from typical commercial negotiations. As distinct from bilateral commercial negotiation, the new entrant comes to the table with little or nothing the incumbent LEC needs or wants. The statute addresses this problem by creating an arbitration proceeding in which the new entrant may assert certain rights, including that the incumbent's prices for unbundled network elements must be "just, reasonable and nondiscriminatory."[10] We adopt rules herein to implement these requirements of section 251(c)(3).

* * *

¶ 29

29. The 1996 Act requires the states to set prices for interconnection and unbundled elements that are cost-based, nondiscriminatory, and may include a reasonable profit. To

[9] Joint Managers' Statement, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 113 (1996) ("Joint Explanatory Statement") at 121.

[10] *See* 47 U.S.C.§ 251(c)(3)

help the states accomplish this, the Commission concludes that the state commissions should set arbitrated rates for interconnection and access to unbundled elements pursuant a forward-looking economic cost pricing methodology. The Commission concludes that the prices that new entrants pay for interconnection and unbundled elements should be based on the local telephone companies Total Service Long Run Incremental Cost of a particular network element, which the Commission calls "Total Element Long-Run Incremental Cost" (TELRIC), plus a reasonable share of forward-looking joint and common costs. States will determine, among other things, the appropriate risk-adjusted cost of capital and depreciation rates. For states that are unable to conduct a cost study and apply an economic costing methodology within the statutory time frame for arbitrating interconnection disputes, the Commission establishes default ceilings and ranges for the states to apply, on an interim basis, to interconnection arrangements. The Commission establishes a default range of 0.2-0.4 cents per minute for switching. For tandem switching, the Commission establishes a default ceiling of 0.15 cents per minute. The Order also establishes default ceilings for the other unbundled network elements.

* * *

¶86

86. The only other possible interpretations would be that: (1) sections 251 and 252 address only interstate aspects of interconnection, services, and access to unbundled elements; (2) the provisions address only the intrastate aspects of those issues; or (3) the FCC's role is to establish rules for interstate aspects, and the states' role is to arbitrate and approve agreements on intrastate aspects. As explained below, none of

these interpretations withstands examination. Accordingly, we conclude that sections 251 and 252 address both interstate and intrastate aspects of interconnection services and access to unbundled elements.

* * *

¶ 123

123. The majority of commenters agree that the Commission's section 208 complaint authority extends to the acts or omissions of common carriers in contravention of sections 251 and 252.[225] TCI further asserts that the Commission retains authority to issue declaratory rulings pursuant to the Administrative Procedure Act, 5 U.S.C. 554(e), and to initiate investigations pursuant to section 403 of the Communications Act.[226] Several state commissions argue, however, that allowing parties to file section 208 complaints would be inconsistent with the states' preeminent role under sections 251 and 252, at least in some circumstances. For example, the New York Commission contends that, to the extent that sections 251 and 252 apply to both interstate and intrastate services, the FCC only has authority to hear

---

[225] *See, e.g.*, ALTS comments at 7; AT&T comments at 10-11; BellSouth comments at 9; CompTel comments at 103; Florida Commission comments at 10-11; Ind. Cable & Telecomm. Ass'n reply at 4; Jones Intercable comments at 13-14; MCI comments at 7-8; MFS comments at 8-9; Ohio Commission comments at 17; Sprint comments at 8-9; TCI comments at 10; TCC comments at 62.

[226] TCI comments at 10.

complaints regarding interstate communications.[227] The Illinois Commission asserts that a section 208 remedy would be appropriate only after an agreement is implemented, and only to the extent the complaint does not allege that the agreement violates standards set forth in sections 251 and 252.[228]

* * *

¶ 176

176. We conclude that the term "interconnection" under section 251(c)(2) refers only to the physical linking of two networks for the mutual exchange of traffic. Including the transport and termination of traffic within the meaning of section 251(c)(2) would result in reading out of the statute the duty of all LECs to establish "reciprocal compensation arrangements for the transport and termination of telecommunications," under section 251(b)(5).[348] In addition, in setting the pricing standard for section 251(c)(2) interconnection, section 252(d)(1) states it applies when state commissions make determinations "of the just and reasonable rate for interconnection of *facilities and equipment* for purposes of subsection (c)(2) of section 251."[349] Because section 251(d)(1) states that it only applies to the interconnection of "facilities and equipment," if we were to interpret section

---

[227] New York Commission reply; *see also* Wyoming Commission comments at 15- 16.

[228] Illinois Commission comments at 16-18.

[348] 47 U.S.C. § 251(b)(5).

[349] 47 U.S.C. § 251(d)(1) (emphasis added).

251(c)(2) to refer to transport and termination of traffic as well as the physical linking of equipment and facilities, it would still be necessary to find a pricing standard for the transport and termination of traffic apart from section 252(d)(1). We also reject CompTel's argument that reading section 251(c)(2) to refer only to the physical linking of networks implies that incumbent LECs would not have a duty to route and terminate traffic. That duty applies to all LECs and is clearly expressed in section 251(b)(5). We note that because interconnection refers to the physical linking of two networks, and not the transport and termination of traffic, access charges are not affected by our rules implementing section 251(c)(2).

* * *

¶¶ 217 - 218

217. Section 202(a) of the Act states that "[i]t shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, ... facilities, or services for or in connection with like communication service ... by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person."[460] By comparison, section 251(c)(2) creates a duty for incumbent LECs "to provide ... any requesting telecommunications carrier, interconnection with a LEC's network on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[461] The nondiscrimination requirement in section 251(c)(2) is not qualified by the "unjust or unreasonable" language of section 202(a). We therefore

---

[460] 47 U.S.C. § 202(a).

[461] 47 U.S.C. § 251(c)(2)(D).

conclude that Congress did not intend that the term "nondiscriminatory" in the 1996 Act be synonymous with "unjust and unreasonable discrimination" used in the 1934 Act, but rather, intended a more stringent standard.

218. Given that the incumbent LEC will be providing interconnection to its competitors pursuant to the purpose of the 1996 Act, the LEC has the incentive to discriminate against its competitors by providing them less favorable terms and conditions of interconnection than it provides itself. Permitting such circumstances is inconsistent with the procompetitive purpose of the Act. Therefore, we reject for purposes of section 251, our historical interpretation of "nondiscriminatory," which we interpreted to mean a comparison between what the incumbent LEC provided other parties in a regulated monopoly environment. We believe that the term "nondiscriminatory," as used throughout section 251, applies to the terms and conditions an incumbent LEC imposes on third parties as well as on itself. In any event, by providing interconnection to a competitor in a manner less efficient than an incumbent LEC provides itself, the incumbent LEC violates the duty to be "just" and "reasonable" under section 251(c)(2)(D). Also, incumbent LECs may not discriminate against parties based upon the identity of the carrier (*i.e.*, whether the carrier is a CMRS provider, a CAP, or a competitive LEC). As long as a carrier meets the statutory requirements, as discussed in this section, it has a right to obtain interconnection with the incumbent LEC pursuant to section 251(c)(2).

* * *

¶¶ 258 - 270

258. We adopt the concept of unbundled elements as physical facilities of the network, together with the features,

functions, and capabilities associated with those facilities. Carriers requesting access to unbundled elements within the incumbent LEC's network seek in effect to purchase the right to obtain exclusive access to an entire element, or some feature, function or capability of that element. For some elements, especially the loop, the requesting carrier will purchase exclusive access to the element for a specific period, such as on a monthly basis. Carriers seeking other elements, especially shared facilities such as common transport, are essentially purchasing access to a functionality of the incumbent's facilities on a minute-by-minute basis. This concept of network elements, as discussed *infra* at section V.G., does not alter the incumbent LEC's physical control or ability or duty to repair and maintain network elements.

259. We conclude that we should identify a particular facility or capability, for example, as a single network element, but allow ourselves and the states (where appropriate) the discretion to further identify, within that single facility or capability, additional required network elements. Thus, for example, in this proceeding, we identify the local loop as a single network element.[553] We also ask the states to evaluate, on a case-by-case basis, whether to require access to subloop elements, which can be facilities or capabilities within the local loop.[554] We agree with those commenters that argue that identifying a particular facility or capability as single network element, but allowing such elements to be further subdivided into additional elements, will allow our rules (as well as the states) to accommodate changes in technology, and thus better serve the interests of new entrants and incumbent LECs, and the procompetitive purposes

---

[553] *See infra*, Section V.J.

[554] *Id.*

of the 1996 Act.[555] We are not persuaded by PacTel's argument that it is unnecessary for our rules to permit the identification of additional elements, beyond those specifically referenced in parts of the 1996 Act, because our rules must conform to the definition of a network element, and they must accommodate changes in technology. Nor are we persuaded by BellSouth that identification of network elements should be left solely to the parties. We reject this approach for the same reasons that led us to adopt national unbundling requirements.[556] Finally, we agree with NYNEX and others that we should not identify elements in rigid terms, but rather by function.

260. We agree with MCI and MFS that the definition of the term network element includes physical facilities, such as a loop, switch, or other node, as well as logical features, functions, and capabilities that are provided by, for example, software located in a physical facility such as a switch.[557] We further agree with MCI that the embedded features and functions within a network element are part of the characteristics of that element and may not be removed from it. Accordingly, incumbent LECs must provide network elements along with all of their features and functions, so that new entrants may offer services that compete with those offered by incumbents as well as new services.

261. The only limitation that the statute imposes on the definition of a network element is that it must be "used in the

[555] *See, e.g.*, District of Columbia Commission comments at 21-22; MFS comments at 36.

[556] *See supra*, Sections II.A, II.B, V.B.

[557] MCI comments at 27-28; MFS comments at 36-37.

provision of a telecommunications service."[558] Incumbent LECs provide telecommunications services not only through network facilities that serve as the basis for a particular service, or that accomplish physical delivery, but also through information (such as billing information) that enables incumbents to offer services on a commercial basis to consumers. Our interpretation of the term "provision" finds support in the definition of the term "network element." That definition provides that the type of information that may constitute a feature or function includes information "used in the transmission, routing or other provision of a telecommunications service."[559] Since "transmission" and "routing" refer to physical delivery, the phrase "or other provision of a telecommunications service" goes beyond mere physical delivery.

262. We conclude that the definition of the term "network element" broadly includes all "facilit[ies] or equipment used in the provision of a telecommunications service," and all "features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a a telecommunications service."[560] This definition thus includes, but is not limited to, transport trunks, call-related databases, software used in such databases, and all

[558] 47 U.S.C. § 153(29).

[559] *Id.*

[560] *Id.*

other unbundled elements that we identify in this proceeding.[561] The definition also includes information that incumbent LECs use to provide telecommunications services commercially, such as information required for pre-ordering,[562] ordering, provisioning,[563] billing, and maintenance and repair services. This interpretation of the definition of the term "network element" will serve to guide both the Commission and the states in evaluating further unbundling requirements beyond those we identify in this proceeding.

263. We disagree with those incumbent LECs which argue that features that are sold directly to end users as retail services, such as vertical features, cannot be considered elements within incumbent LEC networks.[564] If we were to conclude that any functionality sold directly to end users as a service, such as call forwarding or caller ID, cannot be defined as a network element, then incumbent LECs could provide local service to end users by selling them unbundled loops and switch elements, and thereby entirely evade the unbundling requirement in section 251(c)(3).[565] We are confident that Congress did not intend such a result. We further reject Ameritech's argument that we should not permit carriers to use unbundled elements to provide services that are priced above cost at retail. We agree with those parties that argue that competition will not develop

---

[561] *See infra*, V.J.

[562] *See infra*, Section V.J.5, for a definition of pre-ordering services.

[563] The term "provisioning" includes installation.

[564] *See infra*, Section V.J, discussing vertical features and noting that the Illinois Commission has rejected arguments that vertical features cannot be incorporated into network elements.

[565] *See, e.g.*, CompTel reply at 20-22.

if we find that supracompetitive pricing is protected by the 1996 Act.[566]

264. Moreover, we agree with those commenters that argue that network elements are defined by facilities or their functionalities or capabilities, and thus, cannot be defined as specific services. A single network element could be used to provide many different services. For example, a local loop can be used to provision inter- and intrastate exchange access services, as well as local exchange services. We conclude, consistent with the findings of the Ohio and Oregon Commissions, that the plain language of section 251(c)(3) does not obligate carriers purchasing access to network elements to provide all services that an unbundled element is capable of providing or that are typically offered over that element.[567] Section 251(c)(3) does not impose any service-related restrictions or requirements on requesting carriers in connection with the use of unbundled elements.

D. Access to Network Elements

1. Background

265. In the NPRM, we observed that section 251(c)(3) requires incumbent LECs to provide "access" to network elements "on an unbundled basis."[568] We interpreted these

---

[566] *See, e.g.*, DoJ reply at 23-31; CompTel reply at 13-22. For a discussion of the argument that allowing new entrants to purchase vertical features as unbundled elements would nullify section 251(c)(4), *see infra*, Section V.H.

[567] Ohio Commission comments at 33; Oregon Commission comments at 27.

[568] 47 U.S.C. § 251(c)(3).

terms to mean that incumbent LECs must provide carriers with the functionality of a particular element, separate from the functionality of other elements, and must charge a separate fee for each element. We sought comment on this interpretation and any alternative interpretations.[569]

2. Comments

266. A number of parties agree with our interpretation that the phrase "access to network elements on an unbundled basis" means that incumbent LECs must provide access to the functionality of different elements on a separate basis, and must charge separate fees.[570] In contrast, PacTel argues that the 1996 Act does not require the provision of an element's functionality, but merely requires incumbent LECs to provide elements in a way that allows carriers to combine them and offer a telecommunications service. PacTel nevertheless acknowledges that agreements will likely allow for the provision of an element's functionality.[571]

267. Bell Atlantic and USTA argue that "access" to unbundled elements can only be achieved by interconnecting, under the terms of section 251(c)(2), a requesting carrier's

[569] NPRM at para. 86.

[570] BellSouth comments at 34; MFS comments at 41; Cable & Wireless comments at 26-27; MCI comments at 12-20; Ericsson comments at 4; District of Columbia Commission comments at 22; Nextel comments at 8; USTA comments at 26; Colorado Commission comments at 27; Pennsylvania Commission comments at 24-25; GTE comments at 27; Florida Commission comments at 19; GST comments at 19.

[571] PacTel comments at 44-47.

facilities to the facilities of the incumbent LEC at a particular point.[572]

3. Discussion

268. We conclude that we should adopt our proposed interpretation that the terms "access" to network elements "on an unbundled basis" mean that incumbent LECs must provide the facility or functionality of a particular element to requesting carriers, separate from the facility or functionality of other elements, for a separate fee. We further conclude that a telecommunications carrier purchasing access to an unbundled network facility is entitled to exclusive use of that facility for a period of time, or when purchasing access to a feature, function, or capability of a facility, a telecommunications carrier is entitled to use of that feature, function, or capability for a period of time. The specified period may vary depending on the terms of the agreement between the incumbent LEC and the requesting carrier. The ability of other carriers to obtain access to a network element for some period of time does not relieve the incumbent LEC of the duty to maintain, repair, or replace the unbundled network element.[573] We reject PacTel's interpretation of the terms quoted above because it is inconsistent with our definition of the term network element (*i.e.*, an element includes all features and functions embedded

[572] Bell Atlantic comments at 13; USTA comments at 62-63; *see also* GTE comments at 74-79; Letter from Antoinette Cook Bush, Counsel for Ameritech, to William F. Caton, Secretary, FCC, July 10, 1996; *cf.* DoJ comments at 45 (the requirement in section 251(c)(2) that carriers must offer either local exchange or exchange access services does not apply to the carriers offering services using unbundled elements).

[573] We clarify that title to unbundled network elements will not shift to requesting carriers.

in it). Moreover, to the extent that PacTel's argument suggests that the 1996 Act does not require unbundled elements to be provisioned in a way that would make them useful, we find that its statutory interpretation is inconsistent with the statute's goal of providing new entrants with realistic means of competing against incumbents.

269. We further conclude that "access" to an unbundled element refers to the means by which requesting carriers obtain an element's functionality in order to provide a telecommunications service. Just as section 251(c)(2) requires "interconnection ... at any technically feasible point," section 251(c)(3) requires "access ... at any technically feasible point."[574] We conclude, based on the terms of sections 251(c)(2), 251(c)(3), and 251(c)(6), that an incumbent LEC's duty to provide "access" constitutes a duty to provide a connection to a network element independent of any duty imposed by subsection (c)(2). Thus, such "access" must be provided under the rates, terms, and conditions that apply to unbundled elements.

270. Specifically, section 251(c)(6) provides that incumbent LECs must provide "physical collocation of equipment necessary for interconnection *or* access to unbundled network elements."[575] The use of the term "or" in this phrase means that interconnection is different from "access" to unbundled elements. The text of sections 251(c)(2) and (c)(3) leads to the same conclusion. Section 251(c)(2) requires that interconnection beprovided for "the transmission and routing of

[574] 47 U.S.C. §§ 251(c)(2), 251(c)(3).

[575] 47 U.S.C. § 251(c)(6) (emphasis added).

telephone exchange service and exchange access."[576] Section 251(c)(3), in contrast, requires the provision of access to unbundled elements to allow requesting carriers to provide "a telecommunications service."[577] The term "telecommunications service" by definition includes a broader range of services than the terms "telephone exchange service and exchange access."[578] Subsection (c)(3), therefore, allows unbundled elements to be used for a broader range of services than subsection (c)(2) allows for interconnection. If we were to conclude that "access" to unbundled elements under subsection (c)(3) could only be achieved by means of interconnection under subsection (c)(2), we would be limiting, in effect, the uses to which unbundled elements may be put, contrary to the plain language of section 251(c)(3) and standard canons of statutory construction.[579]

* * *

¶ 277 - 288

277. Sections 251(c)(3) and 251(d)(2) set forth standards the Commission must consider in identifying unbundled network elements that incumbent LECs must make available in connection with arbitrations before state commissions and BOC statements of generally available terms and conditions. These standards guide the unbundling requirements we issue today as

[576] 47 U.S.C. § 251(c)(2).

[577] 47 U.S.C. § 251(c)(3).

[578] *See* 47 U.S.C. § 153(16),(46),(47).

[579] *See, e.g.*, DoJ comments at 35-47.

well as any different or additional unbundling requirements we may issue in the future. Similarly, the states must follow our interpretation of these standards to the extent they impose additional unbundling requirements during arbitrations or subsequent rulemaking proceedings

278. Section 251(c)(3) requires incumbent LECs to provide requesting carriers with "nondiscriminatory access to network elements on an unbundled basis at any technically feasible point."[602] We find that this clause imposes on an incumbent LEC the duty to provide all network elements for which it is technically feasible to provide access on an unbundled basis. Because section 251(d)(1) requires us to "establish regulations to implement the requirements of" section 251(c)(3), we conclude that we have authority to establish regulations that are coextensive with the duty section 251(c)(3) imposes on incumbent LECs.

279. Section 251(d)(2), however, sets forth standards that do not depend on technical feasibility. More specifically, section 251(d)(2) provides that, in identifying unbundled elements, the Commission shall "consider, at a minimum," whether access to proprietary elements is necessary (the "proprietary standard"), and whether requesting carriers' ability to provide services would be impaired if the desired elements were not provided by an incumbent LEC (the "impairment standard.") Thus, section 251(d)(2) gives us the authority to decline to require incumbent LECs to provide access to unbundled network elements at technically feasible points if, for example, we were to conclude that access to a particular proprietary element is not necessary. To give effect to both sections 251(c)(3) and 251(d)(2), we conclude that the proprietary and impairment standards in section 251(d)(2) grant us the authority to refrain from requiring

---

[602] 47 U.S.C. § 251(c)(3).

incumbent LECs to provide all network elements for which it is technically feasible to provide access on an unbundled basis. The authority we derive from section 251(d)(2) is limited, however, by our interpretation of these standards, and this section, as set forth below.

280. We agree with BellSouth, SBC, and others that the plain import of the "at minimum" language in section 251(d)(2) requires us, in identifying unbundled network elements, to "consider" the standards enumerated there, as well as other standards we believe are consistent with the objectives of the 1996 Act. We conclude that the word "consider" means we must weigh the standards enumerated in section 251(d)(2) in evaluating whether to require the unbundling of a particular element.

281. We further conclude that, in evaluating whether to impose additional unbundling requirements during the arbitration process, states must apply our definition of technical feasibility, discussed above in section IV.D. A determination of technical feasibility would then create a presumption in favor of requiring an incumbent LEC to provide the element. If providing access to an unbundled element is technically feasible, a state must then consider the standards set forth in section 251(d)(2), as we interpret them below. Similarly, the Commission will apply this analysis where we must arbitrate specific unbundling issues, under section 252(e)(5), and in future rulemaking proceedings that may consider additional or possibly different unbundling requirements.

282. Section 251(d)(2)(A) requires the Commission and the states to consider whether access to proprietary elements is "necessary." "Necessary" means, in this context, that an element is a prerequisite for competition. We believe that, in some instances, it will be "necessary" for new entrants to obtain access to proprietary elements (*e.g.*, elements with proprietary protocols or elements containing proprietary information),

because without such elements, their ability to compete would be significantly impaired or thwarted.[603] Thus, as an initial matter, we decline to adopt a general rule, as suggested by some incumbents, that would prohibit access to such elements, or make access available only upon a carrier demonstrating a heavy burden of need. We acknowledge that prohibiting incumbents from refusing access to proprietary elements could reduce their incentives to offer innovative services. We are not persuaded, however, that this is a sufficient reason to prohibit generally the unbundling of proprietary elements, because the threat to competition from any such prohibition would far exceed any costs to consumers resulting from reduced innovation by the incumbent LEC.[604] Moreover, the procompetitive effects of our conclusion generally will stimulate innovation in the market, offsetting any hypothetical reduction in innovation by the incumbent LECs.

283. We further conclude that, to the extent new entrants seek additional elements beyond those we identify herein, section 251(d)(2)(A) allows the Commission and the states to require the unbundling of such elements unless the incumbent can prove to a state commission that: (1) the element is proprietary, or contains proprietary information that will be revealed if the element is provided on an unbundled basis; and

---

[603] As noted *supra*, Section V.E.2, a number of commenters argue that section 251(d)(2)(A) requires us to protect proprietary information, such as CPNI information, contained in network elements. We intend to treat issues regarding CPNI in our rulemaking proceeding on CPNI information. *Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information*, CC Docket No. 96-115, Notice of Proposed Rulemaking, FCC 96-221 (rel. May 17, 1996).

[604] In this proceeding, for example, we are requiring incumbent LECs to provide the local switching element which includes vertical features that some carriers contend are proprietary. *See infra*, Section V.J.

(2) a new entrant could offer the same proposed telecommunications service through the use of other, nonproprietary unbundled elements within the incumbent's network. We believe this interpretation of section 251(d)(2)(A) will best advance the procompetitive purposes of the 1996 Act. It allows new entrants to obtain proprietary elements from incumbent LECs where they are necessary to offer a telecommunications service, and, at the same time, it gives incumbents the opportunity to argue, before the states or the Commission, against unbundling proprietary elements where a new entrant could offer the same service using other unbundled elements in the incumbent's network. We decline to adopt the interpretation of section 251(d)(2)(A) advanced by some incumbents that incumbent LECs need not provide proprietary elements if requesting carriers can obtain the requested proprietary element from a source other than the incumbent. Requiring new entrants to duplicate unnecessarily even a part of the incumbent's network could generate delay and higher costs for new entrants, and thereby impede entry by competing local providers and delay competition, contrary to the goals of the 1996 Act.

284. We further conclude that, to the extent new entrants do not need access to all the proprietary information contained within an element in order to provide a telecommunications service, the Commission and the states may take action to protect the proprietary information. For example, to provide a telecommunications service, a new entrant might need access to information about a particular customer that is in an incumbent LEC database. The database to which the new entrant requires access, however, may contain proprietary information about all of the incumbent LECs' customers. In this circumstance, the new entrant should not have access to proprietary information about the incumbent LEC's other customers where it is not necessary to provide service to the new entrant's particular

customer. Accordingly, we believe the Commission and the states have the authority to protect the confidentiality of proprietary information in an unbundled network element, such as a database, where that information is not necessary to enable a new entrant to offer a telecommunications service to its particular customer.

285. Section 251(d)(2)(B) requires us to consider whether the failure to provide access to an element would "impair" the ability of a new entrant to provide a service it seeks to offer. The term "impair" means "to make or cause to become worse; diminish in value."[605] We believe, generally, that an entrant's ability to offer a telecommunications service is "diminished in value" if the quality of the service the entrant can offer, absent access to the requested element, declines and/or the cost of providing the service rises. We believe we must consider this standard by evaluating whether a carrier could offer a service using other unbundled elements within an incumbent LEC's network. Accordingly, we interpret the "impairment" standard as requiring the Commission and the states, when evaluating unbundling requirements beyond those identified in our minimum list, to consider whether the failure of an incumbent to provide access to a network element would decrease the quality, or increase the financial or administrative cost of the service a requesting carrier seeks to offer, compared with providing that service over other unbundled elements in the incumbent LEC's network.

286. We decline to adopt the interpretation of the "impairment" standard advanced by most BOCs and GTE. Under their interpretation, incumbent LECs must provide unbundled elements only when the failure to do so would prevent a carrier from offering a service. We also reject the

[605] *See* Random House College Dictionary 665 (rev. ed. 1984).

related interpretations that carriers are not impaired in their ability to provide a service if they can obtain elements from another source, or if they can provide the proposed service by purchasing the service at wholesale rates from a LEC. In general, and as discussed above, section 251(c)(3) imposes on incumbent LECs the obligation to offer on an unbundled basis all network elements for which it is technically feasible to provide access. We believe the plain language of section 251(d)(2), and the standards articulated there, give us the discretion to limit the general obligation imposed by subsection 251(c)(3), but they do not require us to do so. The standards set forth in section 251(d)(2) are minimum considerations that the Commission shall take into account in evaluating unbundling requirements. Accordingly, we conclude that the statute does not require us to interpret the "impairment" standard in a way that would significantly diminish the obligation imposed by section 251(c)(3).

287. The interpretation advanced by most of the BOCs and GTE, described above, means that, if a requesting carrier could obtain an element from a source other than the incumbent, then the incumbent need not provide the element. We agree with the reasoning advanced by some of the commenters that this interpretation would nullify section 251(c)(3) because, in theory, any new entrant could provide all of the elements in the incumbents' networks. Congress made it possible for competitors to enter local markets through the purchase of unbundled elements because it recognized that duplication of an incumbent's network could delay entry, and could be inefficient and unnecessary.[606] The interpretation proffered by the BOCs and GTE would inhibit new entry and thus restrict the potential for meaningful competition, which would undermine the

[606] *See* LDDS comments at 37, reply at 14-15.

procompetitive goals of the 1996 Act. As a practical matter, if it is more efficient and less costly for new entrants to obtain network elements from a source other than an incumbent LEC, new entrants will likely pursue the more efficient and less costly approach. Additionally, as discussed above at section IV.C, we believe that allowing incumbent LECs to deny access to unbundled elements on the grounds that an element is equivalent to a service available at resale would lead to impractical results, because incumbents could completely avoid section 251(c)(3)'s unbundling obligations by offering unbundled elements to end users as retail services.[607]

288. Finally, we decline at this time to adopt any of the additional criteria proposed by commenters. We conclude that none of the additional factors suggested by commenters enhances our ability to identify unbundled network elements consistent with the procompetitive goals of the 1996 Act.[608] These additional considerations would limit unbundling requirements or make it administratively more difficult for new entrants to obtain additional unbundled elements beyond those identified in our minimum list of required elements. For example, we believe that the proposal that new entrants must provide detailed estimates regarding projected market demand is not necessary for incumbent LECs to efficiently plan for network growth.

---

[607] *See infra*, Section V.H, for a further discussion on the relationship between sections 251(c)(3) and 251(c)(4).

[608] *See, e.g.*, Texas Public Utility Counsel comments at 9-11; Cincinnati Bell comments at 15; Nortel comments at 6 (the diversion of research and development efforts to facilities that new entrants do not really want will stifle innovation); SBC comments at 25-37, 84-99.

* * *

¶¶ 292 - 297

292. Under section 251(c)(3), incumbent LECs must provide access to "unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide" a telecommunications service.[619] We agree with the Illinois Commission, the Texas Public Utility Counsel, and others that this language bars incumbent LECs from imposing limitations, restrictions, or requirements on requests for, or the sale or use of, unbundled elements that would impair the ability of requesting carriers to offer telecommunications services in the manner they intend. For example, incumbent LECs may not restrict the types of telecommunications services requesting carriers may offer through unbundled elements, nor may they restrict requesting carriers from combining elements with any technically compatible equipment the requesting carriers own. We also conclude that section 251(c)(3) requires incumbent LECs to provide requesting carriers with all of the functionalities of a particular element, so that requesting carriers can provide any telecommunications services that can be offered by means of the element. We believe this interpretation provides new entrants with the requisite ability to use unbundled elements flexibly to respond to market forces, and thus is consistent with the procompetitive goals of the 1996 Act.

293. We agree with AT&T and Comptel that the quoted text in section 251(c)(3) bars incumbent LECs from separating elements that are ordered in combination, unless a requesting carrier specifically asks that such elements be separated. We

---

[619] 47 U.S.C. § 251(c)(3).

also conclude that the quoted text requires incumbent LECs, if necessary, to perform the functions necessary to combine requested elements in any technically feasible manner either with other elements from the incumbent's network, or with elements possessed by new entrants, subject to the technical feasibility restrictions discussed below. We adopt these conclusions for two reasons. First, in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent. If we adopted NYNEX's proposal, we believe requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets. We therefore reject NYNEX's contention that the statute requires requesting carriers, rather than incumbents, to combine elements. We do not believe it is possible that Congress, having created the opportunity to enter local telephone markets through the use of unbundled elements, intended to undermine that opportunity by imposing technical obligations on requesting carriers that they might not be able to readily meet.

294. Second, given the practical difficulties of requiring requesting carriers to combine elements that are part of the incumbent LEC's network, we conclude that section 251(c)(3) should be read to require incumbent LECs to combine elements requested by carriers. More specifically, section 251(c)(3) provides that incumbent LECs must provide unbundled elements "in a manner that allows requesting carriers to combine them" to provide a telecommunications service. We believe this phrase means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service. The phrase "allows requesting carriers to combine them," does not impose the obligation of physically combining elements exclusively on requesting carriers. Rather, it permits a requesting carrier to

combine the elements if the carrier is reasonably able to do so. If the carrier is unable to combine the elements, the incumbent must do so.[620]

295. Our conclusion that incumbent LECs must combine unbundled elements when so requested is consistent with the method we have adopted to identify unbundled network elements. Under our method, incumbents must provide, as a single, combined element, facilities that could comprise more than one element. This means, for example, that, if the states require incumbent LECs to provision subloop elements, incumbent LECs must still provision a local loop as a single, combined element when so requested, because we identify local loops as a single element in this proceeding.[621]

296. We decline to adopt the view proffered by some parties that incumbents must combine network elements in any technically feasible manner requested. This proposal necessarily means that carriers could request incumbent LECs to combine elements that are not ordinarily combined in the incumbent's network. We are concerned that, in some instances, this could potentially affect the reliability and security of the incumbent's network, and the ability of other carriers to obtain interconnection, or request and use unbundled elements. Accordingly, incumbent LECs are required to perform the functions necessary to combine those elements that are ordinarily combined within their network, in the manner in which they are typically combined. Incumbent LECs are also required to perform the functions necessary to combine elements, even if they are not ordinarily combined in that

---

[620] In this context, we conclude that the term "combine" means connecting two or more unbundled network elements in a manner that would allow a requesting carrier to offer the telecommunications service it seeks to offer.

[621] *See infra*, Section V.J.

manner, or they are not ordinarily combined in the incumbent's network, provided that such combination is technically feasible,[622] or such combination would not undermine the ability of other carriers to access unbundled elements or interconnect with the incumbent LEC's network. Incumbent LECs must prove to state commissions that a request to combine particular elements in a particular manner is not technically feasible, or that the request would undermine the ability of other carriers to access unbundled elements and interconnect because they have the information to support such a claim.

297. We agree with Sprint and the Florida Commission, respectively, that in some cases incumbent LECs may be required to provision a particular element in different ways, depending on the service a requesting carrier seeks to offer; and, in other instances, where a new entrant needs a particular variant of an element to offer a service, that element should be treated as distinct from other variants of the element. This means, for example, that we will treat local loops with a particular type of conditioning[623] as distinct elements that are different from loops with other types of conditioning.[624] As discussed below, we agree with CompTel that incumbent LECs must provide the operational and support systems necessary for requesting carriers to purchase and combine network elements. Incumbent LECs use these systems to provide services to their own end users, and new entrants similarly must have access to them to provide telecommunications services using unbundled

---

[622] As discussed in Section IV, effects on network reliability and security are factors to be considered in determining technical feasibility.

[623] For an explanation of what conditioning of a local loop means *see infra*, Section V.J.1.

[624] Florida Commission comments at 22.

elements.[625] Finally, we agree with BellSouth that requesting carriers must specify to incumbent LECs the network elements they seek before they can obtain such elements on an unbundled basis. We do not believe, however, that it will always be possible for new entrants to do this either before negotiations (or arbitrations) begin, or before they end, because new entrants will likely lack knowledge about the facilities and capabilities of a particular incumbent LEC's network. We further believe that incumbent LECs must work with new entrants to identify the elements the new entrants will need to offer a particular service in the manner the new entrants intend.

* * *

¶¶ 307 - 314

307. We agree with those commenters, including the Florida, Illinois and Washington Commissions, that to achieve the procompetitive goals of the 1996 Act, it is necessary to establish rules that define the obligations of incumbent LECs to provide nondiscriminatory access to unbundled network elements, and to provide such elements on terms and conditions that are just, reasonable and nondiscriminatory.[671] As discussed above at sections II.A, II.B and V.B, we believe that incumbent LECs have little incentive to facilitate the ability of new entrants, including small entities, to compete against them and, thus, have little incentive to provision unbundled elements in a manner that would provide efficient competitors with ameaningful opportunity to compete. We are also cognizant of

---

[625] Incumbent LEC back-office systems are discussed in Section V.J.

[671] *See infra*, Section VII, for a discussion of just, reasonable and nondiscriminatory rates for unbundled network elements.

the fact that incumbent LECs have the incentive and the ability to engage in many kinds of discrimination. For example, incumbent LECs could potentially delay providing access to unbundled network elements, or they could provide them to new entrants at a degraded level of quality.

308. Consistent with arguments advanced by the Florida and Washington Commissions, incumbent LECs, and potential competitors, and as more fully discussed in the specific sections below, we adopt general, national rules defining "nondiscriminatory access" to unbundled network elements, and "just, reasonable, and nondiscriminatory" terms and conditions for the provision of such elements. We have chosen this approach, rather than allowing states exclusively to consider these issues, because we believe that some national rules regarding nondiscriminatory access will reduce the costs of entry and speed the development of competition.[672]

309. We conclude, for example, that national rules defining the 1996 Act's requirements regarding nondiscriminatory access to, and provision of, unbundled elements will reduce costs associated with potential litigation over these issues, and will enable states to conduct arbitrations more quickly by reducing the number of issues they must consider. Such rules will also facilitate the ability of the Commission to conduct arbitrations, should we assume a state's responsibilities under section 252(e)(5). We conclude further that such rules will create some uniformity across states in connection with the terms under which new entrants may obtain access to network elements, thus facilitating the ability of potential competitors, including small entities, to enter local markets on a regional or national scale. Accordingly, for all of these reasons, we reject the arguments of PacTel and USTA that we should not adopt

---

[672] *See supra*, Section V.B.

national rules relating to incumbent LEC obligations to provide access to, and provision, unbundled elements in a nondiscriminatory manner.

310. The record compiled in this proceeding supports the adoption of uniform general rules that rely on states to develop more specific requirements in arbitrations and other state proceedings. More significantly, however, we agree with the California and Florida Commissions that the states are best situated to issue specific rules because of their existing knowledge regarding incumbent LEC networks, capabilities, and performance standards in their separate jurisdictions and because of the role they will play in conducting mediations, arbitrations, and approving agreements. We expect that the states will implement the general nondiscrimination rules set forth herein by adopting, *inter alia*, specific rules determining the timing in which incumbent LECs must provision certain elements, and any other specific conditions they deem necessary to provide new entrants, including small competitors, with a meaningful opportunity to compete in local exchange markets. The states will continue to gain expertise in connection with issues relating to just, reasonable, and nondiscriminatory access and provision of unbundled network elements. We expect to turn to the states, and rely on the expertise they develop in this area, when we review and revise our rules as necessary.

311. We agree with those commenters that argue that incumbent LECs should be required to fulfill some type of reporting requirement to ensure that they provision unbundled elements in a nondiscriminatory manner. We believe the record is insufficient at this time to adopt such requirements, and we may reexamine this issue in the future. We encourage the

states, however, to adopt reporting requirements.[673] We decline to address whether the Commission should consider any of the terms and conditions adopted here in evaluating BOC applications to provide in-region long distance services. We will consider this issue, as it arises, when we evaluate individual BOC applications.

a. Nondiscriminatory Access to Unbundled Network Elements

312. We conclude that the obligation to provide "nondiscriminatory access to network elements on an unbundled basis"[674] refers to both the physical or logical connection to the element and the element itself. In considering how to implement this obligation in a manner that would achieve the 1996 Act's goal of promoting local exchange competition, we recognize that new entrants, including small entities, would be denied a meaningful opportunity to compete if the quality of the access to unbundled elements provided by incumbent LECs, as well as the quality of the elements themselves, were lower than what the incumbent LECs provide to themselves. Thus, we conclude it would be insufficient to define the obligation of incumbent LECs to provide "nondiscriminatory access" to mean that the quality of the access and unbundled elements incumbent LECs provide to all requesting carriers is the same. As discussed above with

[673] We address issues regarding enforcement of the rules we adopt in this Section, regarding nondiscriminatory access to, and just, reasonable and nondiscriminatory terms and conditions for the provision of unbundled network elements, at *supra*, in Section II.E.

[674] 47 U.S.C. § 251(c)(3).

respect to interconnection,[675] an incumbent LEC could potentially act in a nondiscriminatory manner in providing access or elements to all requesting carriers, while providing preferential access or elements to itself. Accordingly, we conclude that the phrase "nondiscriminatory access" in section 251(c)(3) means at least two things: first, the quality of an unbundled network element that an incumbent LEC provides, as well as the access provided to that element, must be equal between all carriers requesting access to that element; second, where technically feasible, the access and unbundled network element provided by an incumbent LEC must be at least equal-in-quality to that which the incumbent LEC provides to itself.[676]

313. We believe that Congress set forth a "nondiscriminatory access" requirement in section 251(c)(3), rather then an absolute equal-in-quality requirement, such as that set forth in section 251(c)(2)(C), because, in rare circumstances, it may be technically infeasible for incumbent LECs to provide requesting carriers with unbundled elements, and access to such elements, that are equal-in-quality to what the incumbent LECs provide themselves. According to some commenters, this problem arises in connection with one variant of one of the unbundled network elements we identify in this order. These commenters argue that a carrier purchasing access to a 1AESS local switch may not be able to receive, for example, the full measure of customized routing features that such a switch may afford the

[675] *See supra*, Sections IV.G, IV.H.

[676] We note that providing access or elements of lesser quality than that enjoyed by the incumbent LEC would also constitute an "unjust" or "unreasonable" term or condition.

incumbent.[677] In the rare circumstances where it is technically infeasible for an incumbent LEC to provision access or elements that are equal-in-quality, we believe disparate access would not be inconsistent with the nondiscrimination requirement. Accordingly, we require incumbent LECs to provide access and unbundled elements that are at least equal-in-quality to what the incumbent LECs provide themselves, and allow for an exception to this requirement only where it is technically infeasible to meet.[678] We expect incumbent LECs to fulfill this requirement in nearly all instances where they provision unbundled elements because we believe the technical infeasibility problem will arise rarely. We further conclude, however, that the incumbent LEC must prove to a state commission that it is technically infeasible to provide access to unbundled elements, or the unbundled elements themselves, at the same level of quality that the incumbent LEC provides to itself.

314. Our conclusion that an incumbent LEC must provide unbundled elements, as well as access to them, that is "at least" equal in quality to that which the incumbent provides itself, does not excuse incumbent LECs from providing, when requested and where technically feasible, access or unbundled elements of higher quality.[679] As we discuss below,[680] we do

---

[677] *See infra*, Section V.J, discussing commenters' arguments regarding the possible technical limitations of such switches.

[678] The exception described here does not excuse incumbent LECs from the obligation to modify elements within their networks to allow requesting carriers to obtain access to such elements where this is technically feasible. *See supra*, Section IV.D.

[679] An incumbent LEC, in accommodating a carrier's request for a particular unbundled element, may ultimately provision an element that is (continued...)

not believe that this obligation is unduly burdensome to incumbent LECs because the 1996 Act requires a requesting carrier to pay the costs of unbundling, and thus incumbent LECs will be fully compensated for any efforts they make to increase the quality of access or elements within their own network.[681] Moreover, to the extent this obligation allows new entrants, including small entities, to offer services that are different from those offered by the incumbent, we believe it is consistent with Congress's goal to promote local exchange competition. We note that, to the extent an incumbent LEC provides an element with a superior level of quality to a particular carrier, the incumbent LEC must provide all other requesting carriers with the same opportunity to obtain that element with the equivalent higher level of quality. We further note that where a requesting carrier specifically requests access or unbundled elements that are lower in quality to what the incumbent LECs provide themselves, incumbent LECs may offer such inferior quality if it is technically feasible. Finally, we conclude that the incumbent LEC must prove to a state commission that it is technically infeasible to provide access to unbundled elements, or the unbundled elements themselves, at a level of quality that is superior to or lower than what the incumbent LEC provides to itself.

---

[679] (...continued)
higher in quality than what the incumbent provides to itself. *See infra*, Section V.J.1.

[680] *See infra*, Section V.J. We require, for example, that incumbent LECs provide local loops conditioned to enable the provision of digital services (where technically feasible) even if the incumbent does not itself provide such digital services.

[681] *See infra*, Section VII.

* * *

¶ 329

329. We reject the arguments advanced by Bell Atlantic and NYNEX that the language of section 251(c)(3) requires carriers seeking access to unbundled elements to own some local exchange facilities, and that this serves to distinguish section 251(c)(3) from section 251(c)(4). The "at any technically feasible point" language in section 251(c)(3) refers to points in an incumbent LEC's network where new entrants may obtain access to elements. It does not, however, require that new entrants interconnect local exchange facilities which they own or control at that technically feasible access point. If we were to conclude otherwise, then new entrants would be prohibited from requesting two network elements that are connected to each other because the new entrant would be required to connect a single network element to a facility of its own. The 1996 Act, however, does not impose any limitations on carriers' ability to obtain access to unbundled network elements. Moreover, we conclude that Congress did not intend to limit access to unbundled elements in this manner because such a limit would seriously inhibit the ability of potential competitors to enter local markets through the use of unbundled elements, and thus would retard the development of local exchange competition. We also reject NYNEX's argument that the phrase "such telecommunications service" excludes services provided by the incumbent. This interpretation is inconsistent with the 1996 Act's definition of a telecommunications service, which includes all telecommunications services provided by an incumbent.

* * *

¶¶ 332 - 333

332. The principal distinction between sections 251(c)(3) and 251(c)(4), in terms of the opportunities each section presents to new entrants, is that carriers using solely unbundled elements, compared with carriers purchasing services for resale, will have greater opportunities to offer services that are different from those offered by incumbents. More specifically, carriers reselling incumbent LEC services are limited to offering the same service an incumbent offers at retail. This means that resellers cannot offer services or products that incumbents do not offer. The only means by which a reseller can distinguish the services it offers from those of an incumbent is through price, billing services, marketing efforts, and to some extent, customer service. The ability of a reseller to differentiate its products based on price is limited, however, by the margin between the retail and wholesale price of the product.

333. In contrast, a carrier offering services solely by recombining unbundled elements can offer services that differ from those offered by an incumbent. For example, some incumbent LECs have capabilities within their networks, such as the ability to offer Centrex, which they do not use to offer services to consumers. Carriers purchasing access to unbundled elements can offer such services. Additionally, carriers using unbundled elements can bundle services that incumbent LECs sell as distinct tariff offerings, as well as services that incumbent LECs have the capability to offer, but do not, and can market them as a bundle with a single price. The ability to package and market services in ways that differ from the incumbent's existing service offerings increases the requesting carrier's ability to compete against the incumbent and is likely

to benefit consumers.[709] Additionally, carriers solely using unbundled network elements can offer exchange access services. These services, however, are not available for resale under section 251(c)(4) of the 1996 Act.[710]

* * *

¶¶ 377 - 396

377. We conclude that incumbent LECs must provide local loops on an unbundled basis to requesting carriers. We note that the Joint Explanatory Statement lists local loops as an example of an unbundled network element.[816] As discussed below, the record demonstrates that it is technically feasible for incumbent LECs to provide access to unbundled local loops, and that such access is critical to encouraging market entry. Further, the competitive checklist contained in section 271 requires BOCs to offer unbundled loops separate from switching as a precondition to entry into the in-region, interLATA services market.[817]

378. Requiring incumbent LECs to make available unbundled local loops will facilitate market entry and improve consumer welfare. Without access to unbundled local loops, new entrants would need to invest immediately in duplicative facilities in order to compete for customers. Such investment

---

[709] *See* AT&T comments at 25-31.

[710] *See infra*, Section VII; *see also* Letter from Bernard J. Ebbers, President LDDS WorldCom, to Rachelle B. Chong, Commissioner, Federal Communications Commission, July 11, 1996.

[816] Joint Explanatory Statement at 116.

[817] 47 U.S.C. § 271(c)(2)(B).

and building would likely delay market entry and postpone the benefits of local telephone competition for consumers. Moreover, without access to unbundled loops, new entrants would be required to make a large initial sunk investment in loop facilities before they had a customer base large enough to justify such an expenditure.[818] This would increase the risk of entry and raise the new entrant's cost of capital. By contrast, the ability of a new entrant to purchase unbundled loops from the incumbent LEC allows the new entrant to build facilities gradually, and to deploy loops for its customers where it is efficient to do so. Moreover, in some areas, the most efficient means of providing competing service may be through the use of unbundled loops. In such cases, preventing access to unbundled loops would either discourage a potential competitor from entering the market in that area, thereby denying those consumers the benefits of competition, or cause the competitor to construct unnecessarily duplicative facilities, thereby misallocating societal resources.

379. Section 251(c)(3) requires incumbent LECs to provide access to unbundled elements "at any technically feasible point."[819] The vast majority of commenters, including incumbent LECs, agree with our tentative conclusion that it is technically feasible to provide access to unbundled local

---

[818] As of year end 1995, Class A carriers reported $268 billion of total plant in service, of which $229 billion was classified as network plant. Local loop plant comprises approximately $109 billion of total plant in service, which represents 41 percent of total plant in service and 48 percent of network plant. *See* 1995 ARMIS Report 43-04.

[819] 47 U.S.C. § 251(c)(3).

loops,[820] and a number of commenters identify the main distribution frame in a LEC central office as an appropriate access point.[821] Moreover, access to unbundled loops is currently provided by several LECs pursuant to state unbundling requirements.[822] Thus, we conclude that it is technically feasible for incumbent LECs to provide access to unbundled local loops at, for example, a central office distribution frame.

380. We further conclude that the local loop element should be defined as a transmission facility between a distribution frame, or its equivalent, in an incumbent LEC central office, and the network interface device at the customer premises. This definition includes, for example, two-wire and four-wire analog voice-grade loops, and two-wire and four-wire loops that are conditioned to transmit the digital signals needed to provide services such as ISDN, ADSL, HDSL, and DS1-level signals.[823]

---

[820] *See, e.g.*, PacTel reply at 18; New York Commission comments at 26; SBA comments at 13-14; TIA comments at 9; GTE reply at 18; NYNEX comments at 64-65.

[821] *See, e.g.*, Bell Atlantic comments, Albers Attachment at 6-8; Ameritech comments at 36.

[822] *See, e.g.*, Ameritech comments at 36 (by the end of 1996, over 45,000 of its unbundled loops will be used by interconnecting carriers); Frontier comments at 14 (Rochester Telephone is currently providing unbundled loops pursuant to tariff); *see also* Alabama Commission Comments at 18; Texas Commission comments at 17; New York Commission comments at 26; Arizona Commission comments, Exh. V at 8.

[823] ISDN (Integrated Services Digital Network) at the Basic Rate Interface level permits the transmission of digital signals over the loop at the rate of 144kbps, which provides two standard 64 kbps voice or data channels and a 16 kbps data channel. ISDN at the Primary Rate Interface permits 23 (continued...)

We note that a number of parties proposed definitions of the local loop that encompassed some or all of these loop types.[824] In addition, we agree with ITIC that the ability to offer various digital loop functions in competition with incumbent LECs may be particularly beneficial to small entities by allowing them to serve niche markets.[825]

381. Incumbent LECs are required to provide access to these transmission facilities only to the extent technically feasible. That is, if it is not technically feasible to condition a loop facility to support a particular functionality, the incumbent LEC need not provide unbundled access to that loop so conditioned. For example, a local loop that exceeds the maximum length allowable for the provision of a high-bit-rate digital service could not feasibly be conditioned for such service.[826] Such a situation may necessitate a request for subloop elements.[827] Nevertheless, section 251(c)(3) does not limit the types of

---

[823] (...continued)
standard 64 kbps channels plus one 16 kbps data channel. ADSL (Asynchronous Digital Subscriber Line) is a transmission path that facilitates 6 Mbps digital signal downstream and 640 kbps digital signal upstream, while simultaneously carrying an analog voice signal. Two-wire HDSL (High-bit-rate Digital Subscriber Line) permits the transmission of a 768 kbps digital signal over a copper loop, while four-wire HDSL allows the transmission of 1.544 Mbps over two two- wire pairs.

[824] *See, e.g.*, MFS comments at 43-44; ALTS comments at 27; GST comments at 21-22; ACSI comments, Att. 1 at 2.

[825] ITIC comments at 7-8.

[826] Such loop conditioning may involve removing load coils or bridged taps that interfere with the transmission of digital signals.

[827] *See, e.g.*, Bell Atlantic reply at 10 n.11.

telecommunications services that competitors may provide over unbundled elements to those offered by the incumbent LEC.

382. Our definition of loops will in some instances require the incumbent LEC to take affirmative steps to condition existing loop facilities to enable requesting carriers to provide services not currently provided over such facilities. For example, if a competitor seeks to provide a digital loop functionality, such as ADSL, and the loop is not currently conditioned to carry digital signals, but it is technically feasible to condition the facility, the incumbent LEC must condition the loop to permit the transmission of digital signals. Thus, we reject BellSouth's position that requesting carriers "take the LEC networks as they find them" with respect to unbundled network elements.[828] As discussed above, some modification of incumbent LEC facilities, such as loop conditioning, is encompassed within the duty imposed by section 251(c)(3).[829] The requesting carrier would, however, bear the cost of compensating the incumbent LEC for such conditioning.[830]

383. We further conclude that incumbent LECs must provide competitors with access to unbundled loops regardless of whether the incumbent LEC uses integrated digital loop carrier technology, or similar remote concentration devices, for the particular loop sought by the competitor. IDLC technology allows a carrier to aggregate and multiplex loop traffic at a remote concentration point and to deliver that multiplexed

[828] BellSouth comments at 39.

[829] *See supra* Section IV.D., interpreting the term "technically feasible." *See also* MFS comments at 43 (arguing that incumbent LECs condition loops in order to provide particular digital loop functionalities to their customers).

[830] *See supra* Section VII, discussing the recovery of costs under section 252(d)(1).

traffic directly into the switch without first demultiplexing the individual loops. If we did not require incumbent LECs to unbundle IDLC-delivered loops, end users served by such technologies would not have the same choice of competing providers as end users served by other loop types. Further, such an exception would encourage incumbent LECs to "hide" loops from competitors through the use of IDLC technology.

384. We find that it is technically feasible to unbundle IDLC-delivered loops. One way to unbundle an individual loop from an IDLC is to use a demultiplexer to separate the unbundled loop(s) prior to connecting the remaining loops to the switch. Commenters identify a number of other methods for separating out individual loops from IDLC facilities, including methods that do not require demultiplexing.[831] Again, the costs associated with these mechanisms will be recovered from requesting carriers.

385. We decline to define a loop element in functional terms, rather than in terms of the facility itself. Some parties advocate defining a loop element as merely a functional piece of a shared facility, similar to capacity purchased on a shared transport trunk.[832] According to these parties, this definition would enable an IXC to purchase a loop element solely for purposes of providing interexchange service. While such a definition, based on the types of traffic provided over a facility, may allow for the separation of costs for a facility dedicated to one end

[831] Under more recent standards for IDLC facilities, a competitor's loop traffic could be separated from the incumbent LEC's loop traffic without the use of multiplexers. *See, e.g.*, MCI comments at 30 (IDLC loops can be moved onto other loop carrier links, or alternatively, can be removed from the mulitiplexed signal through "hair pinning").

[832] *See, e.g.*, Cable & Wireless comments at 26-27; ACTA comments at 17.

user, we conclude that such treatment is inappropriate. Giving competing providers exclusive control over network facilities dedicated to particular end users provides such carriers the maximum flexibility to offer new services to such end users. In contrast, a definition of a loop element that allows simultaneous access to the loop facility would preclude the provision of certain services in favor of others. For example, carriers wishing to provide solely voice-grade service over a loop would preclude another carrier's provision of a digital service, such as ISDN or ADSL, over that same loop.[833] We note that these two types of services could be provided by different carriers over, for example, separate two-wire loop elements to the same end user.

386. Incumbent LECs must provide cross-connect facilities, for example, between an unbundled loop and a requesting carrier's collocated equipment, in order to provide access to that loop. As we conclude in section IV.D, above, an incumbent LEC must take the steps necessary to allow a competitor to combine its own facilities with the incumbent LEC's unbundled network elements. We highlight this requirement for unbundled loops because of allegations by competitive providers that incumbent LECs have imposed unreasonable rates, terms, and conditions for such cross-connect facilities in the past.[834] Incumbent LECs may recover the cost of providing such facilities in accordance with our rules on the costs of interconnection and unbundling. Charges for all such facilities must meet the cost-based standard provided in section 252(d)(1), and the terms and conditions of providing these

[833] Digital services such as ISDN and ADSL occupy the same frequency spectrum on a loop as ordinary voice- grade services.

[834] Intermedia comments at 8-9; Teleport comments at 36-37.

facilities must be reasonable and nondiscriminatory under section 251(c)(3).

387. At this time, we decline to adopt additional terms and conditions, such as the five-minute loop cutover requirement proposed by MFS, for loop provisioning. We agree with commenters who contend that the provisioning of unbundled local loops must be subject to close scrutiny to ensure that incumbent LECs do not delay loop cutover or otherwise complicate the acquisition of loops by a competitor. We conclude, however, that the rules we adopt in the Access to Unbundled Network Elements section that require nondiscriminatory terms and conditions for provisioning, billing, testing, and repair of unbundled elements, and the availability of electronic ordering systems, adequately address these concerns. We will continue to review and revise our rules in this area as necessary.

388. Section 251(d)(2)(A) requires the Commission to consider whether "access to such network elements as are proprietary in nature is necessary."[835] Most parties did not identify any proprietary concerns associated with providing unbundled access to local loops. Ericsson notes that some "active" loop equipment, such as channel banks and remote terminal equipment, is often proprietary in nature, and that manufacturers would require time to modify such equipment to create end-to-end network compatibility on a national basis.[836] Ericsson does not contend, however, that any proprietary information would be revealed if loops using such equipment were unbundled, or that use of such equipment should prevent

[835] 47 U.S.C. § 251(d)(2)(A).

[836] Ericsson comments at 4.

loop unbundling in general.[837] Thus, we conclude that loop elements are, in general, not proprietary in nature under our interpretation of section 251(d)(2)(A). Even if loop elements were proprietary in nature, however, Ericsson does not meet the second consideration in our section 251(d)(2)(A) standard, which requires a showing that a new entrant can offer the proposed telecommunications service through the use of other, nonproprietary elements in the incumbent LEC's network.[838] Ericsson merely contends that manufacturers may need time to establish compatibility between its proprietary equipment and equipment of other manufacturers.[839] Therefore, we find that Ericsson's concerns do not justify withholding unbundled loops from requesting carriers pursuant to section 251(d)(2)(A).

389. Section 251(d)(2)(B) directs the Commission to consider whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[840] We have interpreted the term "impair" to mean either increased cost or decreased service quality that would result from using network elements of the incumbent LEC other than the one sought.[841] Commenters do not identify alternative facilities that would fulfill requesting carriers' need for transmission between the central office and the customer

---

[837] Ericsson's comments were in response to a question in the NPRM seeking comment on the need to accommodate new loop technologies or services. Ericsson comments at 4.

[838] *See supra* Section V.E.3.

[839] Ericsson comments at 4-5.

[840] 47 U.S.C. § 251(d)(2)(B).

[841] *See supra* Section V.E.3.

premises at the same cost and same quality of service. Accordingly, we conclude that competitors' ability to provide telephone exchange, exchange access, or other telecommunications services would be significantly impaired if they did not have the opportunity to purchase unbundled loops from incumbent LECs.

390. As a general matter, we believe that subloop unbundling could give competitors flexibility in deploying some portions of loop facilities, while relying on the incumbent LEC's facilities where convenient. For example, a competitor may seek to minimize its reliance on the LEC's facilities by combining its own feeder plant with the incumbent LEC's distribution plant.[842] In addition, some high bandwidth services, such as ADSL, cannot be provided over long loop lengths. ITIC, Compaq, and Intel assert that subloop unbundling would lead to innovative new data services.[843] In these situations, carriers would need access at points along the loop closer to the customer premises. The record presents evidence primarily of logistical, rather than technical, impediments to subloop

---

[842] Subloop unbundling could have network efficiency advantages as well. One party notes that subloop unbundling could allow packetized data traffic to be shifted to a data network, rather than flowing through the circuit-switched network portions of the public switched network. *See* ITIC July 16 *Ex Parte*.

[843] ITIC July 16 *Ex Parte*, ITAA July 22 *Ex Parte*, Compaq July 23 Ex Parte, Intel July 25 *Ex Parte*. ITAA contends that subloop unbundling would allow data and other traffic to be routed before it reaches an incumbent LEC's central office switch. According to ITAA, such routing would moot incumbent LECs' argument that traffic from the Internet and other on-line services is negatively impacting their switches. ITAA July 19 *Ex Parte*.

unbundling.[844] Several LECs and USTA, for example, assert that incumbent LECs would need to create databases for identifying, provisioning, and billing for subloop elements.[845] Further, incumbent LECs argue that there is insufficient space at certain possible subloop interconnection points.[846] We note that these concerns do not represent "technical" considerations under our interpretation of the term "technically feasible."[847]

391. Nonetheless, we decline at this time to identify the feeder, feeder/distribution interface (FDI), and distribution components of the loop as individual network elements. We find that proponents of subloop unbundling do not address certain technical issues raised by incumbent LECs concerning subloop unbundling. Incumbent LECs contend that access by a competitor's personnel to loop equipment necessary to provide subloop elements, such as the FDI, raise network reliability concerns for customers served through that FDI.[848] SBC, for example, asserts that access to its loop concentration points by competitors would increase the risk of error by a competitor's technicians that may disrupt service to customers of one or both

---

[844] *See, e.g.*, Sprint comments at 30-31; GTE comments at 33-34; NYNEX comments at 68-69; Bell Atlantic comments at 24 (all discussing a variety of tracking, billing, and maintenance issues that would be raised by subloop unbundling).

[845] USTA comments at 31; NYNEX comments at 69; Ameritech comments at 41; BellSouth comments at 39; U S West comments at 50.

[846] Bell Atlantic comments at 24; SBC comments at 38; NYNEX comments at 66.

[847] *See supra* Section IV.D.

[848] BellSouth comments at 39; NYNEX comments at 66; SBC comments at 39; U S West comments at 52 n.113; PacTel comments at 18.

carriers.[849] U S West contends that the potential for poor technical implementation of subloop interconnection and the lack of overall responsibility for loop performance is very likely to degrade overall service quality.[850] Proponents of subloop unbundling do not adequately respond to these arguments by incumbent LECs. As discussed above, we have determined that we must take into account specific, demonstrable claims regarding network reliability in determining whether to identify any particular component as an element that must be unbundled. Therefore, we believe that, at this stage, based on the current record evidence, the technical feasibility of subloop unbundling is best addressed at the state level on a case-by-case basis at this time.[851] Information developed by the parties in the context of a specific request for subloop unbundling will provide a useful framework for addressing the loop maintenance and network reliability matters that we have identified. Based on actions taken by the states or other future developments, and on the importance of subloop unbundling in light of technological advancements, we intend to revisit the specific issue of subloop unbundling sometime in 1997.

392. We require incumbent LECs to offer unbundled access to the network interface device (NID),[852] as a network element, as described below. When a competitor deploys its own loops, the competitor must be able to connect its loops to customers'

---

[849] SBC comments at 39.

[850] U S West comments at 52 n.113.

[851] We encourage states to pursue subloop unbundling in response to requests for subloop elements by competing providers.

[852] The NID is a cross-connect device used to connect loop facilities to inside wiring.

inside wiring in order to provide competing service, especially in multi-tenant buildings. In many cases, inside wiring is connected to the incumbent LEC's loop plant at the NID. In order to provide service, a competitor must have access to this facility. Therefore, we conclude that a requesting carrier is entitled to connect its loops, via its own NID, to the incumbent LEC's NID.[853]

393. Pursuant to section 251(c)(3), we find that this arrangement clearly is technically feasible. Ameritech notes that it currently maintains such connections with competitors that have deployed their own loop facilities.[854] This is persuasive evidence that unbundled access at the NID, in this manner, does not raise network reliability concerns. Under section 251(d)(2)(A), the record contains no evidence of proprietary concerns with unbundled access to the NID. In addition, under our interpretation of the "impair" test of section 251(d)(2)(B), commenters do not contend that new entrants could obtain the same functionality at the same cost and service quality through other network elements of the incumbent LEC. Moreover, the record indicates that certain network architectures used by new entrants, such as fiber rings, can most efficiently connect end users to the new entrant's switching

---

[853] We emphasize that access to inside wiring through the incumbent LEC's NID does not entitle a competitor to deliver its loop facilities into a building without the permission of the building owner. Similarly, access to an incumbent LEC's NID does not entitle the competitor to the riser and lateral cables between the NID and individual units within the building, which may be owned or controlled, for example, by the premises owner.

[854] Letter from James K. Smith, Director-Federal Relations, Ameritech, to William F. Caton, Acting Secretary, FCC, July 15, 1996 (Ameritech July 15 *Ex Parte*).

office without use of the incumbent LEC's facilities.[855] Thus, we conclude that the unavailability of access to incumbent LECs' NIDs would impair the ability of carriers deploying their own loops to provide service. Further, we believe that unbundled access to the NID will facilitate entry strategies premised on the deployment of loops. As discussed in section VII, above, the new entrant bears the costs connecting its NID to the incumbent LEC's NID.

394. We do not require an incumbent LEC to permit a new entrant to connect its loops directly to the incumbent LEC's NID. MCI contends that directly connecting its loops to incumbent LECs' NIDs is "[t]he only practical solution" for gaining access to inside wiring.[856] According to MCI, there is no extra wiring to connect the incumbent LEC's NID to the new entrant's NID.[857] Ameritech demonstrates, however, that it currently provides access to inside wiring through the type of arrangement that MCI asserts is not practical -- that is, by connecting a new entrant's loops to inside wiring via the new entrant's NID and Ameritech's NID. MCI does not demonstrate that its ability to provide competing service is unreasonably limited by the arrangements explained by Ameritech.

395. The record contains conflicting evidence on the technical feasibility of requiring incumbent LECs to permit competitors to connect their loops directly to incumbent LECs' NIDs. Ameritech asserts that such a direct connection would leave Ameritech's unused loops without overvoltage

---

[855] Letter from Don Sussman, MCI, to William F. Caton, FCC, July 12, 1996 (MCI July 12 *Ex Parte*).

[856] MCI July 12 *Ex Parte* at 6.

[857] *Id.* at 5.

protection.[858] MCI argues that overvoltage protection is provided through the incumbent LEC's "protector module" that is separate from the NID.[859] Ameritech responds that its NIDs are integrated units providing both overvoltage protection and a demarcation point, and that these two functions of the NID are "inseverable."[860] AT&T contends direct access to incumbent LECs NIDs is technically feasible. According to AT&T, if a competitor connects its loops directly to the incumbent LEC's NID, the incumbent LEC's loops remain connected to the grounding equipment that protects against overvoltage.[861] According to AT&T, when the competitor does not use spare terminals on the NID, the competitor would be required to ground the incumbent LEC's unused loops to protect against overvoltage.[862]

396. We find that the record in this proceeding does not permit a determination on the technical feasibility of the direct connection of a competitor's loops to the incumbent LEC's NID. Our requirement of a NID-to-NID connection addresses the most critical need of competitors that deploy their own loops -- obtaining access to the inside wiring of the building.

---

[858] Ameritech July 15 *Ex Parte* at 5.

[859] Letter from Donald Evans, Vice President - Federal Regulatory Affairs, MCI, to William F. Caton, Secretary, FCC, July 16, 1995 (MCI July 16 *Ex Parte*).

[860] Letter from James Smith, Director-Federal Relations, Ameritech, to William F. Caton, Acting Secretary, FCC, July 24, 1996 (Ameritech July 24 *Ex Parte*).

[861] Letter from Bruce Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, July 18, 1996 (AT&T July 18 *Ex Parte*).

[862] *Id.*

We recognize, however, that competitors may benefit by directly connecting their loops to the incumbent LEC's NID, for example, by avoiding the cost of deploying NIDs.[863] States should determine whether direct connection to the NID can be achieved in a technically feasible manner in the context of specific requests by competitors for direct access to incumbent LECs' NIDs.[864]

* * *

¶ 412

412. We define the local switching element to encompass line-side and trunk- side facilities plus the features, functions, and capabilities of the switch.[912] The line-side facilities include the connection between a loop termination at, for example, a main distribution frame (MDF), and a switch line card.[913] Trunk-side facilities include the connection between, for

---

[863] *Id.* at 1.

[864] Ameritech July 15 *Ex Parte* at 5-6.

[912] The NPRM used the terms "switch platform" and "port," as they had been developed by the Illinois and New York Commissions, respectively, to describe two possible approaches to establishing an unbundled local switching element. Parties commenting on the unbundled switching element attributed a variety of functionalities to each of these terms. To avoid confusion, we will not use these terms in discussing the unbundled local switching element. Instead, we will address commenters' proposals according to the functionality that they recommend be included in the definition of an unbundled local switching element.

[913] A line card is a plug-in electronic printed circuit card that operates ringing, holding, and other features associated with one or several telephone lines.

example, trunk termination at a trunk-side cross-connect panel and a trunk card. The "features, functions, and capabilities" of the local switch include the basic switching function of connecting lines to lines, lines to trunks, trunks to lines, trunks to trunks. It also includes the same basic capabilities that are available to the incumbent LEC's customers, such as a telephone number, directory listing, dial tone, signaling, and access to 911, operator services, and directory assistance.[914] In addition, the local switching element includes all vertical features that the switch is capable of providing, including custom calling, CLASS features, and Centrex, as well as any technically feasible customized routing functions. Thus, when a requesting carrier purchases the unbundled local switching element, it obtains all switching features in a single element on a per-line basis. A requesting carrier will deploy individual vertical features on its customers' lines by designating, via an electronic ordering interface, which features the incumbent LEC is to activate for particular customer lines.

---

[914] Purchasing the local switching element does not entitle a requesting carrier to connect its own AIN call processing database to the incumbent LEC's switch, either directly or via the incumbent LEC's signal transfer point or database. Section V.I.4, which discusses the unbundling of incumbent LECs' signaling systems and databases. We also note that E911 and operator services are further unbundled from local switching. *See infra* Section V.I.6.

* * *

¶¶ 618 - 740

VII. PRICING OF INTERCONNECTION AND UNBUNDLED ELEMENTS

A. Overview

618. The prices of interconnection and unbundled elements, along with prices of resale and transport and termination, are critical terms and conditions of any interconnection agreement. If carriers can agree on such prices voluntarily without government intervention, these agreements will be submitted directly to the states for approval under section 252. To the extent that the carriers, in voluntary negotiations, cannot determine the prices, state commissions will have to set those prices. The price levels set by state commissions will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* and favors one party (whether favoring incumbents or entrants) or, as we believe Congress intended, *pro-competition*. As discussed more fully in Section II.D. above, it is therefore critical to implementing Congress's pro-competitive, de-regulatory national policy framework to establish among the states a common, pro-competition understanding of the pricing standards for interconnection and unbundled elements, resale, and transport and termination. While such a common interpretation might eventually emerge through judicial review of state arbitration decisions, we believe that such a process could delay competition for years and require carriers to incur

substantial legal costs.[1490] We therefore conclude that, to expedite the development of fair and efficient competition, we must set forth rules now establishing this common, pro-competition understanding of the 1996 Act's pricing standards. Accordingly, the rules we adopt today set forth the methodological principles for states to use in setting prices. This section addresses interconnection and unbundled elements, and subsequent sections address resale and transport and termination, respectively.

619. While every state should, to the maximum extent feasible, immediately apply the pricing methodology for interconnection and unbundled elements that we set forth below, we recognize that not every state will have the resources to implement this pricing methodology immediately in the arbitrations that will need to be decided this fall. Therefore, so that competition is not impaired in the interim, we establish default proxies that a state commission shall use to resolve arbitrations in the period before it applies the pricing methodology. In most cases, these default proxies for unbundled elements and interconnection are ceilings, and states may select lower prices. In one instance, the default proxy we establish is a price range. Once a state sets prices according to an economic cost study conducted pursuant to the cost-based pricing methodology we outline, the defaults cease to apply. In setting a rate pursuant to the cost-based pricing methodology, and especially when setting a rate above a default proxy ceiling or outside the default proxy range, the state must give full and fair effect to the economic costing methodology we set forth in this Order and must create a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate.

[1490] For a discussion of our legal authority to adopt national pricing rules, *see supra*, Section II.D.

620. In the following sections, we first set forth generally, based on the current record, a cost-based pricing methodology based on forward-looking economic costs, which we conclude is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market- determined prices and forward-looking economic costs. If market prices exceed forward-looking economic costs, new competitors will enter the market. If their forward-looking economic costs exceed market prices, new competitors will not enter the market and existing competitors may decide to leave. Prices for unbundled elements under section 251 must be based on cost under the law, and that should be read as requiring that prices be based on forward-looking economic costs. New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants' investment decisions would be distorted if the price of unbundled elements were based on embedded costs. In arbitrations of interconnection arrangements, or in rulemakings the results of which will be applied in arbitrations, states must set prices for interconnection and unbundled network elements based on the forward-looking, long-run, incremental cost methodology we describe below. Using this methodology, states may not set prices lower than the forward- looking incremental costs directly attributable to provision of a given element. They may set prices to permit recovery of a reasonable share of forward-looking joint and common costs of network

elements.[1491] In the aftermath of the arbitrations and relying on the state experience, we will continue to review this costing methodology, and issue additional guidance as necessary.

621. We reject various arguments raised by parties regarding the recovery of costs other than forward-looking economic costs in section 251(c)(2) and (c)(3) prices, including the possible recovery of: (1) embedded or accounting costs in excess of economic costs; (2) incumbent LECs' opportunity costs; (3) universal service subsidies; and (4) access charges. As discussed in Section VII.B.2.a. below, certain portions of access charges may continue to be collected for an interim period in addition to section 251(c)(3) prices.

622. With respect to prices developed under the forward-looking, cost-based pricing methodology, we conclude that incumbent LECs' rates for interconnection and unbundled elements must recover costs in a manner that reflects the way they are incurred. We adopt certain rules that states must follow in setting rates in arbitrations. These rules are designed to ensure the efficient cost- based rates required by the 1996 Act.

623. In the next section of the Order, we establish default proxies that states may elect to use prior to utilizing an economic study and developing prices using the cost-based pricing methodology. We recognize that certain states may find it difficult to apply an economic costing methodology within the statutory time frame for arbitrating interconnection disputes. We therefore set forth default proxies that will be relatively easy to apply on an interim basis to interconnection arrangements. We discuss with respect to particular unbundled elements the reasonable rate structure for those elements and

---

[1491] We define these and other forward-looking cost concepts *infra*, Section VII.B.2.a. We define what we consider to be a reasonable share of forward- looking joint and common costs *infra*, Section VII.B.2.a.

the particular default proxies we are establishing for use pending our adoption of a generic forward-looking cost model. Finally, we discuss the following additional matters: generic forward-looking costing models that we intend to examine further by the first quarter of 1997 in order to determine whether any of those models, with modifications, could serve as better default proxies; the future adjustment of rates; the relationship of unbundled element prices to retail prices; and the meaning of the statutory prohibition against discrimination in sections 251 and 252.

624. Those states that have already established methodologies for setting interconnection and unbundled rates must review those methodologies against the rules we are adopting in this Order. To the extent a state's methodology is consistent with the approach we set forth herein, the state may apply that methodology in any section 252 arbitration. However, if a state's methodology is not consistent with the rules we adopt today, the state must modify its approach. We invite any state uncertain about whether its approach complies with this Order to seek a declaratory ruling from the Commission.

B. Cost-Based Pricing Methodology

625. As discussed more fully in Section II.D. above, although the states have the crucial role of setting specific rates in arbitrations, the Commission must establish a set of national pricing principles in order to implement Congress's national policy framework. For the reasons set forth in the preceding section and as more fully explained below, we are adopting a cost-based methodology for states to follow in setting interconnection and unbundled element rates. In setting forth the cost-based pricing methodology for interconnection and access to unbundled elements, there are three basic sets of

questions that must be addressed. First, does the 1996 Act require that the same standard apply to the pricing of interconnection provided pursuant to section 251(c)(2), and unbundled elements provided pursuant to section 251(c)(3)? Second, what is the appropriate methodology for establishing the price levels for interconnection and for each unbundled element, how should costs be defined, and is the price based on economic costs, embedded costs, or other costs? Third, what are the appropriate rate structures to be used to set prices designed to recover costs, including a reasonable profit? We address each of these questions in the following sections.

1. Application of the Statutory Pricing Standard

a. Background

626. In the NPRM, we proposed that any pricing principles we adopt should be the same for interconnection and unbundled network elements because sections 251(c)(2) and (c)(3) and 252(d)(1) use the same pricing standard.[1492] We invited parties to comment on this issue and to justify any proposed distinction in the priority for interconnection and unbundled network elements. We also stated our belief that the same pricing rules that apply to interconnection and unbundled network elements should also apply to collocation under section 251(c)(6) of the 1996 Act.

b. Comments

627. Commenters generally agree that any pricing rules adopted by the Commission for interconnection and

[1492] NPRM at para. 122.

unbundled elements should be the same.[1493] These parties assert that any pricing rules the Commission ultimately adopts should not, therefore, create incentives to substitute or arbitrage one type of classification for another. Commenters also generally agree that the pricing rules the Commission adopts for interconnection and unbundled elements should also apply to collocation.[1494] Many of these parties agree that collocation is a subset of the interconnection arrangements contemplated by sections 251(c)(2) and 252(d)(1).[1495] On the other hand, a few parties contend that the pricing standards contained in section 252(d)(1) for interconnection and unbundled elements do not apply to collocation provided under section 251(c)(6).[1496] BellSouth argues that the Commission should not adopt any national standards for virtual collocation.[1497] Other commenters, including some that oppose the establishment of pricing rules by the Commission, argue that, to the extent that the Commission adopts national standards for collocation, they should generally follow those established in the Commission's

[1493] *See, e.g.*, Citizens Utilities comments at 16 n.14; Ohio Commission comments at 42; Teleport comments at 46.

[1494] *E.g.*, ACSI comments at 16; ALTS comments at 34-35; Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MCI comments at 54, 61; MFS comments at 30; NEXTLINK comments at 26; PacTel comments at 63; Sprint comments at 42; Teleport comments at 46.

[1495] *See, e.g.*, Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MFS comments at 30; NEXTLINK comments at 26.

[1496] *See, e.g.*, SNET comments at 24 n

[1497] BellSouth comments at 23.

Expanded Interconnection proceeding in CC Docket No. 91-141.[1498]

c. Discussion

628. Sections 251(c)(2) and (c)(3) impose an identical duty on incumbent LECs to provide interconnection and access to network elements "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[1499] In addition, both interconnection and unbundled network elements are made subject to the same pricing standard in section 252(d)(1). Based on the plain language of sections 251(c)(2), (c)(3), and section 252(d)(1), we conclude that Congress intended to apply the same pricing rules to interconnection and unbundled network elements. The pricing rules we adopt shall, therefore, apply to both.

629. We further conclude that, because section 251(c)(6) requires that incumbent LECs provide physical collocation on "rates, terms, and conditions that are just, reasonable, and nondiscriminatory," which is identical to the standard for interconnection and unbundled elements in sections 251(c)(2) and (c)(3), collocation should be subject to the same pricing rules.[1500] We also note that, because collocation is a method of obtaining interconnection and access to unbundled network elements, collocation is properly treated under the same pricing rules. This legal conclusion that there should be a single set of pricing rules for interconnection, unbundled network elements, and collocation provides greater consistency and guidance to the industry, regulators, and the courts.

[1498] *See, e.g.*, Bell Atlantic comments at 32-34.

[1499] 47 U.S.C. § 251(c)(2), (c)(3).

[1500] *See supra*, Section VI.B.

Moreover, it reduces the regulatory burdens on state commissions of developing and applying different pricing rules for collocation, interconnection, and unbundled network elements. We note that our adoption of this single set of pricing rules should minimize regulatory burdens, conflicts, and uncertainties associated with multiple, and possibly inconsistent rules, thus facilitating competition on a reasonable and efficient basis minimizing the economic impact of our rules for all parties, including small entities and small incumbent LECs.[1501]

2. Rate Levels

a. Pricing Based on Economic Cost

(1) Background

630. We observed in the NPRM that economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.[1502] We noted, however, that there was a lack of general agreement on the specifics of methodology for deriving prices based on LRIC or total service long-run incremental cost (TSLRIC). We invited parties to comment on whether we should require the states to employ a LRIC-based pricing methodology and to explain with specificity the costing methodology they support.[1503] We recognized, however, that prices based on LRIC might not permit recovery of forward-looking costs if there were significant forward-looking joint and common costs among

---

[1501] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1502] NPRM at para. 124.

[1503] *Id.* at para. 126.

network elements.[1504] We sought comment on how, if rates are set above incremental cost, to deal with the problems inherent in allocating common costs and any other overheads.[1505] We observed that, by defining the unbundled elements at a sufficiently aggregated level, it may be possible to reduce the costs to be allocated as joint and common by identifying a substantial portion of costs as incremental to a particular element. To the extent that joint and common costs cannot be entirely eliminated, we sought comment on various methodologies for assigning them, including the use of a fixed allocator or on the basis of inverse demand elasticity. We also sought comment on whether, regardless of the method of allocating common costs, we should limit rates to levels that do not exceed stand-alone costs.[1506] Finally, we invited parties to comment on whether a LRIC-based methodology would establish a price for interconnection and unbundled network elements that includes a reasonable profit and thus complies with section 252(d)(1).[1507]

631. A number of states already employ, or have plans to utilize, some form of LRIC or TSLRIC methodology in their approach to setting prices for unbundled network elements,[1508] with several states choosing LRIC or TSLRIC as

---

[1504] *Id.* at para. 129.

[1505] *Id.* at para. 130.

[1506] *Id.* For a definition of stand-alone costs, *see* Section VII.B.2.a. *infra*.

[1507] 47 U.S.C. § 252(d)(1)(A)(i); NPRM at para. 129.

[1508] *See, e.g.*, California Commission comments at 29 (California has adopted TSLRIC as the standard for developing the costs of unbundled elements and in a rulemaking this summer will determine the unbundled (continued...)

a price floor.[1509] For instance, the Connecticut Commission adopted a TSLRIC methodology to measure the cost of service of SNET, its principal incumbent LEC.[1510] Arizona also requires incumbent LECs to conduct TSLRIC cost studies to establish the underlying cost of unbundled services and facilities.[1511] The Ohio Commission has adopted Long Run Service Incremental Cost ("LRSIC"), which is closely related

---

[1508] (...continued)
network elements and what level of shared and common costs should be included in the price of each); Michigan Commission comments at 13 (1996 prices for loops to remain at levels established by the Michigan Commission in its original interconnection order or at TSLRIC); Texas Commission comments at 22 (Texas Commission has employed LRIC-based pricing methodologies for many years; SWBT and GTE required to file LRIC cost studies to be used in pricing not later than November 1, 1996).

[1509] *See, e.g.*, Colorado Commission comments at Attachment (Rules Prescribing Principles for Costing and Pricing of Regulated Services of Telecommunications Service Providers) 4 CCR 723-30, Rules 4-5; Hawaii Administrative Rules, Sections 6-80-32-34 (setting out a three-tiered pricing regime with TSLRIC set as floor for pricing of competitive services); Louisiana Commission comments at Attachment (Louisiana Public Service Commission "Regulations for Competition in the Local Telecommunications Market"), p.30; Washington Commission comments at 25, Appendix B (*Washington Utilities and Transportation Commission v. U S West Communications*, Docket No. UT-950200 at 82 (Washington Commission, April 11, 1996)); Wisconsin Stat. Ann. section 196.204 (requiring the price of each network service or function to exceed TSLRIC).

[1510] Connecticut Commission comments at 4.

[1511] Arizona Commission comments, Exhibit V (Arizona Administrative Code R14-2-1101 *et seq.*), p. 10.

to TSLRIC.[1512] The Missouri and Wyoming Commissions are among a number of state commissions that have not yet adopted a pricing methodology, but are considering LRIC or TSLRIC.[1513] Oklahoma law provides for submission of LRIC cost studies and studies identifying a contribution to common costs for interconnection of facilities and access to network elements to the Oklahoma Commission during an arbitration.[1514] A number of states have yet to choose a pricing methodology. For instance, the New York Commission sets prices on a case-by- case basis.[1515] Unbundled element prices also exist in several states pursuant to negotiated interconnection agreements that have either already been approved by state commissions or are under consideration.[1516]

[1512] *See* Ohio Commission comments at 43-45.

[1513] *See, e.g.*, Missouri Commission comments at 11 (supports LRIC for costing; LRIC is defined in pending state legislation); Wyoming Commission comments at 26-27 (draft rules propose use of TSLRIC as a price floor, with prices to include a contribution to shared, common, and joint costs, and the sum of prices for unbundled elements not to exceed retail for bundled services; incumbent LECs shall impute the prices of unbundled elements into the price floors of each of their own services that utilize the network elements).

[1514] Oklahoma Commission comments at Appendix A (Corporation Commission Telephone Rules OAC 165:55-17-25), pp. 10-11.

[1515] *Competition, The State Experience* at 80 (compilation of written responses by state commission staffs to questions by FCC staff, compiled by NARUC) (March 8, 1996).

[1516] According to information in our possession, such agreements have been negotiated in, among other states, Alabama, Florida, Georgia, Kentucky, Illinois, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee. Letter from W.W. Jordan, Executive Director-- Federal (continued...)

632. Section 252(d)(1) requires, *inter alia*, that rates for interconnection and unbundled network elements be based on "cost (determined without reference to a rate-of-return or other rate-based proceeding)."[1517] We tentatively concluded in the NPRM that this language precludes states from setting rates by use of traditional cost-of service regulation, with its detailed examination of historical carrier investment and expenses.[1518] Instead, we indicated our belief that the statute contemplates the use of other forms of cost-based price regulation, such as the setting of prices based on forward-looking economic cost methodologies (such as LRIC) that do not involve the use of an embedded rate base. We sought comment on whether section 252(d)(1) forecloses consideration of historical or embedded costs or merely prohibits state commissions from conducting a traditional rate-of-return proceeding to establish prices for interconnection and unbundled network elements. Embedded costs are the costs that the incumbent LECs carry on their accounting books that reflect historical purchase prices, regulatory depreciation rates, system configurations, and operating procedures. We invited parties to comment on

---

[1516] (...continued)
Regulatory, BellSouth, to William F. Caton, Acting Secretary, July 11, 1996 at Attachment (containing chart detailing agreements between BellSouth and new entrants in Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee); "Interconnection Agreement Under Sections 251 and 252 of the telecommunications Act of 1996, by and between, Ameritech Information Industry Services and MFS Intelenet of Illinois, Inc.," dated May 17, 1996 filed July 25, 1996).

[1517] 47 U.S.C. § 252(d)(1)(B).

[1518] NPRM at para. 123.

whether incumbent LECs should be permitted to recover some portion of their historical or embedded costs over TSLRIC.[1519]

633. In the NPRM, we noted that certain incumbent LECs had advocated that interconnection and access to unbundled element prices be based on the "efficient component pricing rule" (ECPR).[1520] Under this approach, an incumbent LEC that sells an essential input element, such as interconnection, to a competing network would set the price of that input element equal to "the input'sdirect per-unit incremental costs plus the opportunity cost to the input supplier of the sale of a unit of input."[1521] We tentatively concluded in the NPRM that ECPR or equivalent methodologies are inconsistent with the section 252(d)(1) requirement that rates be based on "cost," and we proposed to preclude the states from using this methodology.[1522]

634. Section 254 requires the Commission and the Joint Board established thereunder to ensure that "[a]ll providers of telecommunications service ... make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service ... ." That section further provides that "[t]here should be specific, predictable, and sufficient Federal and State mechanisms to preserve and

---

[1519] *Id.* at para. 129.

[1520] *Id.* at para. 147. *See* William J. Baumol, *Some Subtle Issues in Railroad Deregulation*, 10 Int'l J. Trans. Econ. 341 (1983); William Baumol & Gregory Sidak, *Toward Competition in Local Telephony* (1994); William Baumol & Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171 (1994).

[1521] William Baumol & Gregory Sidak, *The Price of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171, 178.

[1522] NPRM at para. 148.

advance universal service."[1523] The Conference Committee also explained that these provisions require any such universal service support payment to be, to the extent possible, "explicit, rather than implicit as many support mechanisms are today."[1524] In the NPRM, we sought comment on whether "it would be consistent with sections 251(d)(1) and 254 for states to include any universal service costs or subsidies in the rates they set for interconnection, collocation, and unbundled network elements."[1525] In particular, we discussed the "play or pay" system adopted by the state of New York in which interconnectors that agree to serve all customers in their self-defined service areas ("players") potentially pay a substantially lower interconnection rate than those that serve only selected customers ("payers") and are, therefore, liable to pay additional contribution charges.[1526] We noted that the statutory schedule for the completion of the universal service reform proceeding (15 months from the enactment of the 1996 Act) is different from that for this proceeding (6 months from the date of enactment of the 1996 Act). We asked whether the ability of states to take universal service support into account differs pending completion of the section 254 Joint Board proceeding or state universal service proceedings, pursuant to section

---

[1523] 47 U.S.C. § 254(b)(4) and (b)(5).

[1524] Joint Explanatory Statement at 130-31. "In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit." *Id.* at 131; *See also* 47 U.S.C. § 254(e).

[1525] NPRM at para. 145.

[1526] *Id.*

254(f), during any transition period that may be established in the section 254 proceeding or thereafter.[1527]

(2) Comments

635. *Forward-Looking Costs.* Most new entrants and IXCs agree that prices for interconnection and unbundled elements should be based on forward-looking, economic costs.[1528] Many state commissions also argue that, if federal pricing rules are adopted, forward-looking methodologies should serve as the basis for establishing rates in a competitive environment.[1529] The Department of Justice contends that pricing above forward-looking economic costs would subject competitors to substantial risk of a price squeeze because the real cost of a network element for the incumbent LEC will be its forward- looking economic cost, while the cost to the new entrant will be the higher price charged for the element by the LEC.[1530] Parties favoring a forward- looking, incremental cost methodology argue that it is the appropriate pricing standard for

---

[1527] *Id.*

[1528] *See, e.g.*, ACSI comments at 54-55; AT&T comments at 47; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 59, 61; NEXTLINK comments at 27; Sprint comments at 43-44; Teleport comments at 46; Telecommunications Resellers Ass'n comments 38-39; *See also* Ad Hoc Telecommunications Users Committee comments at 31-34; DoJ comments at 27-32; Frontier comments at 21-22; Texas Public Utility Counsel comments at 33-34; Attorneys General reply at 3; NCTA reply at 18-20; NTIA reply at 17-18 n.35.

[1529] *See, e.g.*, New York Commission comments at 3-4; Missouri Commission comments at 11; Kentucky Commission comments at 4-5; Wyoming Commission comments at 27-28; Ohio Commission comments at 41-43.

[1530] DoJ comments at 28-31.

several reasons. First, such an approach simulates the prices for network elements that would result if there were a competitive market for the provision of such elements to other carriers.[1531] In such a market, these parties argue, competition would drive prices to forward-looking costs, even if such costs were lower than a firm's historical costs.[1532] Second, unbundled element prices based on forward-looking economic costs prevent incumbent LECs from exploiting their market power at the expense of their competitors that are dependent on the incumbent LEC's facilities.[1533] Third, a forward-looking incremental cost methodology creates the right investment incentives for competitive facilities-based entry and creates incentives for the market to move towards competition while preserving opportunities for competition even if some network elements prove to be resistant to competition.[1534] Fourth, a pricing methodology based on forward-looking economic costs minimizes the incumbent LECs' opportunities to engage in anticompetitive cross-subsidization that could delay the emergence of effective competition.[1535] Finally, these parties

---

[1531] *See, e.g.*, DoJ comments at 28-29.

[1532] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.5; DoJ comments at 28-29.

[1533] *See, e.g.*, DoJ comments at 30.

[1534] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.7; DoJ comments at 29; NCTA comments at Appendix B (Unbundling, Interconnection, and Traffic Exchange: The Pricing of Access to Local Exchange Networks), p. 22.

[1535] *See, e.g.*, DoJ comments at 30-31.

argue that pricing based on forward-looking economic costs will lead to lower prices for consumers.[1536]

636. While many commenters agree that the proper economic cost standard for interconnection and unbundled elements is one based on forward-looking LRIC, the record indicates a lack of consensus on the precise definition of such a methodology. While many parties, including some incumbent LECs, favor a pricing methodology based on TSLRIC,[1537] others contend that LRIC provides the appropriate basis for pricing interconnection and unbundled elements.[1538] AT&T argues that, because incumbent LECs will be providing access to unbundled network elements and interconnection, and not merely the individual services that use those elements, the relevant question is the incumbent LEC's cost of producing the

---

[1536] *See, e.g.*, DoJ comments at 28-31.

[1537] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 34-36; AT&T comments at 47-48; ALTS comments at 35-36; Ameritech comments at 63-64 (but must include recovery of joint, common, and residual costs); CFA/CU comments at 26-32 (including a contribution to joint and common costs); Citizens Utilities comments at 18; Comcast comments at 23; CompTel comments at 67-71; Competition Policy Institute comments at 8; DoJ comments at 28-31 (including any joint and common costs); Frontier comments at 21-22; Intermedia comments at 14; LDDS comments at 56, 62; MCI comments at 60-61; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24-25 (including a markup over TSLRIC to reflect a reasonable allocation of joint and common costs); SNET reply at 5-7 (including a reasonable contribution to common costs); Sprint comments at 44 (plus a reasonable contribution to joint and common costs), reply at 28-32; TCC comments at 14.

[1538] *See, e.g.*, Texas Statewide Tel. Cooperative comments at 8-11, 14.

entire demand for network elements.[1539] Because TSLRIC defines a cost increment relative to a hypothetical situation in which the supplier does not currently provide the network element at all and thus must construct and operate all element-specific facilities necessary to produce the network element, AT&T believes that TSLRIC, unlike LRIC, includes all element-specific fixed costs.[1540]

637. The Consumer Federation of America argues that costs must be analyzed consistently across all major services using the same cost methodology, *i.e.*, individual functionalities or specific capacities must have similar costs across services.[1541] AT&T argues that TSLRIC should exclude all costs attributable to the incumbent LECs' retailing operations, and that all other cost allocations should be competitively-neutral and assigned on an equally proportional basis relative to attributable costs.[1542] ALTS argues that the underlying data from a TSLRIC study should be accessible for purposes of replicating the study methods and comparisons to other public data.[1543] NTIA contends that the Commission should require the states to consider recovery of only those costs that the incumbent can convincingly demonstrate are

---

[1539] AT&T comments at 47, Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.6.

[1540] *Id.* at 48.

[1541] CFA/CU comments at 32.

[1542] AT&T comments at 61-62, 64-65.

[1543] ALTS comments at 36-37.

incurred in service provisioning.[1544] Supporters of a forward-looking economic cost methodology argue that TSLRIC studies can be prepared quickly to establish interconnection and unbundled element prices.[1545]

638. Incumbent LECs generally oppose the adoption of a forward-looking, long- run incremental costing methodology.[1546] At least five major reasons are offered in opposition. First, opponents of a forward-looking, long-run incremental costing methodology argue that setting the price of each discrete service based on LRIC will not recover the total costs of the network because if prices are set equal to the cost of the last unit, total revenues will fall short of total costs.[1547] Second, PacTel argues that a forward-looking cost methodology also suffers from the "fallacy of perfect competition" because it does not account for the fact that, while it is true that competition drives the price of every product toward incremental cost, every multi-product firm must have some products priced far enough above incremental cost to recover its total costs and return a profit to investors.[1548] Third, incumbent LECs argue that setting prices based on the forward-looking economic cost of the element will not create incentives for new

---

[1544] NTIA reply at 28.

[1545] *See, e.g.*, LDDS comments at 64-65.

[1546] *See, e.g.*, Matanuska comments at 3-4; NYNEX comments at 46-47; PacTel comments at 66-67; TCA comments at 8.

[1547] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp.3-4; NECA comments at 8; Rural Tel. Coalition comments at 25.

[1548] PacTel comments at 68-69; *see also* Rural Tel. Coalition reply at 26-27.

entrants to build their own facilities,[1549] and will discourage efficient entry and useful investment by both incumbent LECs and their competitors.[1550] Fourth, some opponents of a forward-looking, economic cost methodology contend that such an approach raises significant practical and administrative problems because LRIC studies are expensive to conduct, almost impossible to audit or review particularly for small entities seeking to enter the local exchange market, highly subjective, and the necessary data are under the exclusive control of the party subject to the agreement.[1551] USTA and other commenters also argue that use of LRIC cost studies would fail to capture differences in geographic regions, thereby denying small incumbent LECs a reasonable opportunity to recover their costs.[1552] Finally, many opponents of a forward-looking, economic cost approach to pricing interconnection and access to unbundled elements argue also that such a methodology precludes any contribution to joint and common costs and does not allow the recovery of historical costs.[1553]

[1549] *See, e.g.*, Bell Atlantic comments at 38; SBC comments at 91-92.

[1550] *See, e.g.*, PacTel comments at 70; SBC comments at 90-92; *see also* U S West comments at Exhibit A (Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange), p.9.

[1551] *See, e.g.*, Bell Atlantic comments at Attachment 2 (Declaration of Robert W. Crandall), p.8; MFS comments at 54, reply at 11-12; NECA comments at 8.

[1552] *E.g.*, USTA comments at 45-50; Bay Springs reply at 8.

[1553] *See, e.g.*, BellSouth comments at 56-57; NYNEX comments at 50-52; PacTel comments at 65-66; SBC comments at 88, reply at 24-25; U S West reply at 9, 12 (stating that depreciation expenses should be properly allocated); *see also* NECA comments at 8; TCA comments at 8-9. For a

(continued...)

These parties contend that network providers must be permitted to recover their total costs of service, including a return on investment and a reasonable allocation of joint, common, and historical costs.[1554]

639. Incumbent LECs generally contend that costs should be based on the individual incumbent LEC's existing network design and technology instead of the idealized least-cost, most efficient network design and technology.[1555] USTA argues that, if competitors want to use an incumbent LEC's embedded plant, competitors should pay for the existing plant, not some theoretical, more efficient plant.[1556] In addition, these parties argue that, if a new entrant can purchase the unbundled element from the incumbent LEC at a price no higher than the cost of the least-cost, most efficient provider, then the new entrant has little incentive to invest in its own facilities. Ameritech also contends that section 252(d)(1) addresses recovery of the incumbent LEC's costs of providing

---

[1553] (...continued)
discussion of recovery of joint, common, and embedded costs, *see infra* Section VII.B.2.a.

[1554] *See, e.g.*, Ameritech comments at 60, reply at 30-33 (stating that residual cost recovery must also be permitted); Bell Atlantic comments at 35- 36 (stating that the recovery of the total costs of constructing and operating the networks must also be permitted); NYNEX comments at 42-44; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp

[1555] *See, e.g.*, Ameritech reply at 32-33; Bell Atlantic reply at 17-18; Bellsouth reply at 36-37; *see also* GVNW comments at 36; USTA comments at 40, reply at 21-22.

[1556] USTA comments at 40.

interconnection and unbundled network elements, not the costs of a hypothetical carrier.[1557]

640. On the other hand, several new entrants argue that a forward-looking economic cost methodology should be based on an efficient provider's costs of producing a service.[1558] These parties contend that, in a competitive market, prices are determined by the cost of efficient potential entrants, not the embedded costs of existing firms.[1559] In addition, a pricing standard based on the costs of the element using the most-efficient technology prevents incumbent LECs from charging competitors for the cost of facilities that would in fact be used in large part by the incumbent LECs themselves to compete in new markets such as interexchange service.[1560] Sprint, however, argues that prices should be based on the incumbent LEC's average utilization and existing network design and technology, not on an idealized network and technology that

---

[1557] Ameritech reply at 32.

[1558] *See, e.g.*, ACSI comments at 56; AT&T comments at 57-60 (optimally configured and sized assets with current technology and efficient operating practices); AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p. 10 (efficient, cost-minimizing competitor); GST comments at 26-27 (costs of an efficient LEC rather than the actual costs of an incumbent LEC); Teleport reply at 30 (best available technology at today's prices); *see also* DoJ reply at 9-11 (best generally available technology); Louisiana Commission comments at 4, 15; Telecommunications Resellers Ass'n comments at 38 (most efficient available technology).

[1559] *See, e.g.*, TCC comments at 17.

[1560] DoJ reply at 10.

may bear no relationship to the incumbent LECs existing operations.[1561]

641. USTA, Bell Atlantic, and BellSouth have asserted in various filings and *ex parte* presentations that TSLRIC-based pricing would not properly compensate incumbent LECs for certain factors that affect capital costs and economic depreciation rates.[1562] First, when technological progress lowers equipment costs, the replacement or forward-looking economic cost of certain durable sunk investments can be expected to decline over time. In this case the correct measure of cost over any period of time should include the expected decline in economic value during that period.[1563]

642. Second, these parties argue that, when investments in facilities needed to meet a specific level of demand are sunk and irreversible, an incumbent LEC may not be able to recover these costs over the physical life of the facility, because demand may decreaseas new entrants elect to build their own facilities. When entry is possible using current technology, either competition from these entrants, or rate regulation can prevent retail service prices from rising

---

[1561] Sprint reply at 31-32.

[1562] USTA reply comments at Attachment 1 (Reply Affidavit of Jerry A. Hausman); Bell Atlantic comments at Attachment 1(Affidavit of Jerry A. Hausman); Letter from Robert T. Blau, Vice President, Executive and Federal Regulatory Affairs, BellSouth, to William F. Caton, Acting Secretary, FCC, July 25, 1996, at Attachment (Response to Hubbard and Lehr).

[1563] We note that USTA seems to present a contradictory argument regarding the expected effect of this issue -- here Hausman claims that prices will decrease rapidly, whereas in our price cap proceeding, USTA sponsored testimony by Christenson that claimed input prices would generally increase at the rate of inflation. USTA comments in CC Docket No. 94-1, at 25-27.

significantly, which will place an effective ceiling on profits. If demand for a service falls in a market in which the incumbent LEC is the only supplier and owner of sunk facilities, however, there will be no corresponding exit of other carriers that will prevent prices and profits from falling. Because of this asymmetric effect of changing market conditions on an incumbent LEC's profits, these parties claim that increasing the uncertainty due to entry in the local exchange market will increase the cost of capital to the incumbent LEC. They then assert that the inability of TSLRIC to account for the risks associated with sunk facilities can lead to understating the true economic cost of an element by a factor of three.[1564] Finally they assert that empirical research that shows firms' hurdle rates in excess of the market cost of capital shows that the considerations of risk associated with sunk investment significantly raises a firm's cost of capital.[1565]

643. *Joint and Common Costs*. Several incumbent LECs contend that a forward- looking, economic cost methodology does not take into account either joint or common costs.[1566] Although a few parties contend that incumbent LECs do not need a mark-up over TSLRIC to recover joint and common costs because incumbents are presumably already

---

[1564] *See* USTA reply at Attachment 1 (Reply Affidavit of Jerry A. Hausman), p.1.

[1565] *Id.* at 7.

[1566] *See, e.g.*, Bell Atlantic comments at Tab 2 (Declaration of Robert W. Crandall), p.9, reply at Attachment 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), p.6; BellSouth comments at 51; Municipal Utilities comments at 19-21; SBC reply at 24-25; TDS comments at 18-19.

recovering these costs,[1567] commenters generally agree that incumbent LECs should be permitted to recover some measure of forward-looking joint and common costs.[1568] These commenters argue that pricing at incremental cost without joint and common costs is economically inefficient because it permits competitors to offer the incumbent LECs' services without making a contribution to the common costs that the LECs incur in offering the service.[1569] They further contend that excluding recovery of joint and common costs will distort technological decisions because the LEC is encouraged to invest in less efficient technologies that have higher incremental costs and lower common costs, which would tend to destroy economies of scope.[1570] Finally, incumbent LECs fear that they will be forced to increase retail rates to recover these unrecovered common costs, while their competitors that do not

---

[1567] *See* Telecommunications Resellers Ass'n comments at 39-40; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29, reply at 9-10.

[1568] *See, e.g.*, Ameritech comments at 60; Bell Atlantic comments at 36; Citizens Utilities comments at 19; Cincinnati Bell comments at 24-25; Colorado Commission comments 45-46; DoJ reply at 6; GTE Comments at 61-62; Kentucky Commission comments at 5; Lincoln Tel. comments at 13; Mass. Commission comments at 11-12; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24; SBC comments at 91; Sprint comments at 43-44; AT&T reply at 28; NTIA reply at 19-21; USTA reply at 19.

[1569] *E.g.*, BellSouth comments at 52-53; GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.3.

[1570] *See, e.g.*, BellSouth comments at 53; Lincoln Tel. comments at 13.

face such costs will reduce their own prices and have little incentive to invest in facilities of their own.[1571]

644. There is no consensus in the record on the magnitude of the joint and common costs at stake. Although commenters argued that the amount of common costs varies dramatically due to differences in location, network construction, and equipment,[1572] several parties are skeptical that there are significant joint and common costs between network elements given the relative modularity of the network and associated functions.[1573] These parties contend that, if joint and common costs are incurred, incumbent LECs must quantify them so that a state commission can determine whether and precisely how much contribution is needed.[1574] The Department of Justice asserts that, when developing a TSLRIC for unbundled network elements, it is preferable, where possible, to focus on costs of facilities and network elements rather than services that use those facilities in order to arrive at a more accurate determination of economic costs and to reduce the amount of costs that must be treated as joint or common.[1575] The incumbent LECs disagree with the new entrants' characterization of these costs as *de minimis* and argue that

---

[1571] *E.g.*, BellSouth comments at 53-54.

[1572] *See, e.g.*, Municipal Utilities comments at 19-20; NARUC reply at 9.

[1573] *See, e.g.*, AT&T comments at Attachment or Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.13-14; Competition Policy Institute comments at 19; DJ comments at 31-32, reply at 8; Texas Public Utility Counsel comments at 24-25.

[1574] Texas Public Utility Counsel comments at 17-28; Sprint comments at 47- 50.

[1575] DoJ reply at 8; *see also* Competition Policy Institute comments at 19.

there is no evidence that unrecovered joint and common costs are much lower in the TSLRIC rates for physical elements than a TSLRIC standard based on the cost of providing services.[1576]

645. There is considerable disagreement in the record over the appropriate method of allocating joint and common costs under a TSLRIC approach. AT&T contends that the vast majority of the relevant costs will be causally attributed to particular network elements in the calculation of TSLRIC, and that we should prescribe rigid allocators that limit the incumbents' ability to manipulate prices by imposing high markups on new entrants.[1577] This approach, it is argued, is more competitively neutral than Ramsey pricing, which allocates costs based on inverse demand elasticity.[1578] In contrast, incumbent LECs advocate allocation of joint and common costs based on inverse demand elasticity,[1579] *i.e.*, according to Ramsey pricing principles.[1580] New entrants and other parties oppose the use of Ramsey pricing for interconnection and unbundled network elements for use in a

---

[1576] *E.g.*, PacTel reply at 27; *see also* Cincinnati Bell reply at 10.

[1577] *See* AT&T comments at 61-62.

[1578] *See, e.g.*, Teleport comments at 47-48.

[1579] *See e.g.*, GTE comments at 63, comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), pp.4-6; *see also* Mass. Commission comments at 11- 12.

[1580] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991).

market that is moving toward competition over the long-run.[1581] They contend that Ramsey pricing enables LECs to shift costs associated with entry into new competitive markets over to captive services.[1582] One state commission responds that the Commission's concern in this regard would be addressed by calculating demand elasticities on the basis of the total industry demand for the service, which would negate the influence of competition on demand elasticities.[1583]

646. Commenters suggested other means of allocating joint and common costs. For example, certain incumbent LECs argue that these costs must not be shifted from interconnection and unbundled elements to residential subscribers,[1584] while certain new entrants suggest that these costs should be recovered at the retail level.[1585] Many new entrants agree that the Commission should require allocation of joint and common costs that minimizes the opportunity for incumbent LECs to harm competitors through strategic pricing.[1586] For example, some new entrants argue that states should be required to minimize allocation of joint and common costs to bottleneck or

---

[1581] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 39-41; CompTel comments at 79-80; MECA comments at 45; Teleport comments at 47-48; Texas Public Utility Counsel comments at 27; WinStar reply at 10-11.

[1582] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 38-39.

[1583] *See, e.g.*, Mass. Commission comments at 12.

[1584] *See, e.g.*, Puerto Rico Tel. comments at 10; Rural Tel. Coalition comments at 27.

[1585] *E.g.*, MCI reply at 9-10.

[1586] *See, e.g.*, MCI reply at 9-10.

essential network elements.[1587] MCI and Sprint assert that such costs should be spread across all services provided by a carrier in proportion to the TSLRIC for each service.[1588] A few commenters assert that the Commission should adopt a fixed mark-up over TSLRIC for allocation of joint and common costs.[1589] Cable & Wireless supports the adoption of a rule that allocates common costs uniformly for all services offered. It argues that a disproportionate allocation system, that for example, assigns common costs strictly to retail services purchased for resale by small companies, but not to unbundled network elements utilized by larger competitors, would prove detrimental to the development of local competition.[1590] Finally, certain parties suggested that regardless of the method ultimately used to allocate joint and common costs, TSLRIC

[1587] *See, e.g.*, LCI comments at 4-5 (even under a TSLRIC methodology, it may be necessary to allocate joint direct costs among classes of service); Time Warner comments at 52-53 (only elements that can be duplicated by competitors or that are already available from other sources should include a reasonable markup over TSLRIC for shared and common costs); *see also* CFA/CU comments at 33-35 (allocation to such elements should be no more than the allocation of such costs to basic service).

[1588] *See* AT&T comments at 64; MCI reply at 9-10; Sprint comments at 47.

[1589] *See, e.g.*, Competition Policy Institute comments at 19 (suggesting an overhead loading of six percent); *see also* Sprint comments at 48-49 (joint and common costs should be no more than 15 percent of TSLRIC)

[1590] Cable & Wireless comments at 35.

should serve as the floor[1591] and prices should not exceed stand-alone costs.[1592]

647. *Reasonable Profit.* Commenters disagree over what should constitute a "reasonable profit." Numerous commenters argue that a TSLRIC-based methodology for the pricing of interconnection and unbundled network elements includes a reasonable profit and is, therefore, consistent with the 1996 Act.[1593] These commenters argue that economic measures, such as TSLRIC, reflect a reasonable profit by including the cost of capital.[1594] Time Warner and NEXTLINK contend that permitting incumbent LECs to receive a profit above that contained within TSLRIC pricing would provide them with a greater return on facilities than was permitted under rate-of-return regulation by "double- counting" the profit.[1595] Furthermore, NEXTLINK rejects the notion that profit includes the recovery of embedded costs or is a means of recovering

---

[1591] *See, e.g.*, Citizens Utilities comments at 19; Florida Commission comments at 26; SBC comments at 93-94.

[1592] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.14-15; TDS comments at 21.

[1593] *See, e.g.*, CompTel comments at 69-70; LDDS comments at 61; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29; Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p. 12.

[1594] *E.g.*, AT&T reply at 31; CompTel comments at 69-70, reply at 39; DoJ reply at 9; Frontier reply at 12-15; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29.

[1595] NEXTLINK comments at 28; Time Warner reply at 31-32.

subsidies for universal service currently recovered through access charges such as the transport interconnection charge or carrier common line charge, or their intrastate equivalents.[1596] Similarly, LDDS believes that "reasonable profit" cannot be read to include contribution to costs having nothing to do with providing the network elements or interconnection that are the subject of a section 252 pricing standard.[1597]

648. Incumbent LECs, however, contend that setting rates on a TSLRIC-based methodology alone would violate section 252(d)(1) by precluding recovery of a reasonable profit.[1598] NYNEX and USTA state that profit is what a firm makes after it recovers its total costs of providing all of its services, including its investment-related costs.[1599] Ameritech similarly contends that the term "reasonable profit" means the ability to earn positive economic profits as an incentive for efficiency and innovation.[1600] PacTel argues that, in order to allow for a reasonable profit, rates for interconnection and unbundled elements must permit full recovery of historical accounting costs. PacTel charges that the federal courts have held that the determination of a "reasonable profit" should consider the effect on the carrier's whole enterprise and,

---

[1596] NEXTLINK comments at 28-29.

[1597] LDDS comments at 61.

[1598] *See, e.g.*, GTE comments at 60; NYNEX comments at 51-52; PacTel comments at 69; SBC comments at 88; TCA comments at 9; TDS comments at 18; *see also* GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.9.

[1599] *See* NYNEX comments at 42; USTA comments at 43.

[1600] *See* Ameritech comments at 70-71.

therefore, the sum of the carrier's rates must enable it to recover its total historical costs.[1601]

649. Several parties contend that the issue of what constitutes a reasonable profit should be left to the states. Citizen Utilities contends that the issue of whether profit is reasonable is a question of fact to be resolved, where necessary, in arbitration proceedings.[1602] Time Warner argues that what constitutes reasonable profit should, as a matter of policy, vary depending on the nature of the facilities or services being provided and should, therefore, be left to the states.[1603] The Illinois Commission argues that states may even use rate-of-return methodologies for the determination of reasonable profit.[1604]

650. There is also disagreement among the commenters regarding the force of the reasonable profit language in section 252. While many incumbent LECs interpret Section 252(d)(1) as *requiring* prices to include a reasonable profit,[1605] certain new entrants and other parties argue that the reasonable profit language is permissive, not mandatory.[1606] For example, several LECs contend that, to avoid confiscation of their property, LECs are entitled to full operating expenses as

---

[1601] *See* PacTel comments at 65-66, *citing FPC v. Hope Natural Gas*, 320 U.S. 591 (1944) and *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1172 (D.C. Cir. 1987).

[1602] Citizens Utilities comments at 17.

[1603] Time Warner comments at 52.

[1604] Illinois Commission reply at 15.

[1605] *See, e.g.*, PacTel comments at 65-66.

[1606] *See, e.g.*, AT&T reply at 31; Cox reply at 29; DoJ reply at 15.

well as the capital costs of doing business and a reasonable profit.[1607] The Ohio Consumers' Counsel, however, argues that the language of section 252(d)(1) indicates that it is at the discretion of the state commissions to determine whether to allow rates to reflect a reasonable profit.[1608]

651. USTA contends that "purely forward-looking TSLRIC" should not be the price for interconnection elements because "telecommunications networks are mostly sunk costs."[1609] It argues that, when investment in facilities requires sunk and irreversible costs, a firm may not be able to recover this investment over the physical life of the facilities due to the risks of decreases in value resulting from future competition. USTA contends that allowing other carriers into the provision of local exchange service will subject incumbent LECs to these types of risks. It then claims that TSLRIC calculations do not appropriately account for these additional risks.

652. USTA also argues that the risks to which the incumbent LECs will be subject as a result of competition in the local exchange market include the risks from facing new competition, technological change, change in demand, and interest rates. It further argues that these risks will result in many situations in which the incumbent LECs may face a reduction in profits (downside risk) and no situations in which the incumbent LECs may see an increase in their profits. Thus, incumbent LECs must be compensated for these additional risks, according to USTA. It concludes that TSLRIC

[1607] *See, e.g.*, MECA comments at 44, 49; PacTel comments at 65-67.

[1608] Ohio Consumers' Counsel comments at 26.

[1609] *See* USTA reply at Attachment 1 (Reply Affidavit of Professor Jerry A. Hausman), p.1.

calculations fail to provide this compensation, stating "TSLRIC can be biased downward by a factor of three."[1610]

653. Similarly, Bell Atlantic asserts that, in a market where input prices are declining, a TSLRIC standard is not the appropriate standard because, "in a world of continual technological progress, it would be irrational for firms constantly to update their facilities in order completely to incorporate today's lowest-cost technology."[1611] Thus, it argues that because a carrier would not replace its entire existing set of facilities (a sunk investment) with the best available technology at a given point, the price of the best available technology understates the cost of providing service.[1612]

654. The Consumer Federation of America, disputing the incumbent LECs' claims regarding risk premiums, argues that risk premiumsare reflected in the large returns incumbent LECs have already earned.[1613]

655. *Embedded Costs.* IXCs, competitive local entrants, and others interpret section 251(d)(1) as precluding states from setting rates by use of traditional cost-of-service regulation, with its detailed examination of historical

---

[1610] *Id.* at 6. Presumably, by TSLRIC, Professor Hausman is referring to a TSLRIC assuming a risk free rate of return and a depreciation rate that encompasses the physical life of assets.

[1611] Bell Atlantic reply at Exhibit 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), para.8a.

[1612] *Id.*

[1613] *See* CFA/CU comments at 61-63.

accounting costs and reliance on an embedded rate base.[1614] These parties argue that some measure of forward-looking economic costs, not historical costs, should be the only basis for setting rates for interconnection and unbundled network elements because only forward-looking economic costs meet the statutory requirement in section 252(d)(1) that such rates be "determined without reference to a traditional rate-of-return or other rate-based proceeding." Potential new entrants and many other commenters argue that historical or embedded costs should not be included in the prices of interconnection and unbundled network elements.[1615] NTIA asserts that it is unwise to include in the prices for interconnection and unbundled elements an amount to recover historical costs when the size of any shortfall between historical costs and TSLRIC's forward-

[1614] *See, e.g.*, AT&T comments at 47; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Sprint comments at 43; Teleport comments at 46; Time Warner comments at 51; Frontier comments at 21; Excel comments at 9; ACSI comments at 54-55; WinStar comments at 37-38; GST comments at 29-30; *see also* Ad Hoc Telecommunications Users Committee comments at 30-31; DoJ comments at 27-32, reply at 14; Kentucky Commission comments at 4; Texas Public Utility Counsel comments at 33-34; Telecommunications Resellers Ass'n comments at 38; Michigan Commission comments at 14; Pennsylvania Commission comments at 29; Ohio Commission comments at 42-43; Attorneys General reply at 7-8.

[1615] *See, e.g.*, AT&T comments at 47; CFA/CU reply at 18-19; DoJ comments at 27-32; N. Economides comments at 3; Frontier comments at 21-22, reply at 13; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Michigan Commission comments at 14; Sprint comments at 43; Teleport comments at 46; TCC comments at 15-16; Texas Public Utility Counsel comments at 33-34; Time Warner comments at 51; WinStar comments at 37-38; *see also* Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), pp.2-6;

looking costs will not be determined for many years after interLATA entry.[1616] These parties contend that permitting incumbent LECs to recover embedded costs in the prices they charge competitors for interconnection and unbundled network elements, while the incumbents experience much lower incremental costs, will result in inefficiently high prices that will either cause new entrants to over-build existing systems instead of maximizing the efficient use of the existing incumbent LEC's network, or discourage entry and investment in the local markets altogether.[1617] Moreover, opponents of embedded cost recovery maintain that these costs reflect past inefficiencies and their recovery does not create any incentive for incumbent LECs to maximize their network and operational efficiencies.[1618] Commenters also argue that embedded cost recovery permits incumbents to engage in anticompetitive, strategic, or discriminatory pricing by manipulating the cost of individual rate elements.[1619]

656. In response to claims that the incumbent LECs are entitled to recover embedded costs incurred as a result of their regulation, opponents of embedded cost recovery argue that, at the state level, incumbent LECs have been opting for incentive-based regulation and so have foregone the right to claim entitlement to recovery of embedded costs in exchange

[1616] *See* NTIA reply at 28-29.

[1617] *See, e.g.*, Competition Policy Institute comments at 8; TCC comments at 15-16.

[1618] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 53-54.

[1619] TCC comments at 15-16

for the flexibility to price their services to meet competition.[1620] AT&T argues that, because the majority of the incumbent LECs' embedded plant was installed after 1990, the forward-looking replacement costs of this old plant may in many cases be higher than the incumbent LECs' embedded costs.[1621] MCI disagrees with incumbent LECs' claims that excluding historical costs will discourage future investment by incumbent LECs and argues instead that incumbent LECs make investment decisions based upon expected future earnings.[1622]

657. Most incumbent LECs and some other parties dispute the claim that historical costs are precluded by the statute,[1623] asserting instead that section 252(d)(1) merely prohibits the use of a rate-of-return *proceeding* to determine such rates.[1624] Incumbent LECs argue that any pricing methodology the Commission adopts should permit recovery of historical or embedded costs in the prices of interconnection

---

[1620] *See, e.g.*, GST comments at 29-30; WinStar comments at 38.

[1621] *See* AT&T reply at 33. For a detailed discussion, *See* AT&T reply at Appendix C (Affidavit of Lee Selwyn and Patricia Kravtin), pp.1-4.

[1622] *See* MCI reply at 15-16.

[1623] *See, e.g.*, Bell Atlantic comments at 37; BellSouth reply at 35-37; Colorado Commission comments at 34-35; GVNW comments at 35-36; Municipal Utilities comments at 19; NYNEX comments at 46-47; Ohio Consumers' Counsel comments at 23; PacTel comments at 65; Roseville Tel. comments at 6-8; Rural Tel. Coalition comments at 26-28; SBC comments at 88; TDS comments at 17-18; Texas Statewide Telephone Coop. Inc. comments at 7; USTA comments at 40.

[1624] *See, e.g.*, Bell Atlantic comments at 37; Municipal Utilities comments at 19; Ohio Consumers' Counsel comments at 23; Texas Statewide Telephone Coop. comments at 7.

and unbundled network elements.[1625] NYNEX specifically proposes a cost-accounting pricing methodology that places the burden on the incumbent LEC to identify the specific accounting data that would be associated with the particular type of interconnection requested by the competing carrier under section 251.[1626]

658. USTA cites reports that estimate that embedded costs that would not be recouped under a solely forward-looking pricing methodology are between $13 billion and $18.4 billion.[1627] Incumbent LECs contend that, because incumbent LECs must offset this shortfall of revenues against total costs that is created by a failure to recover embedded costs, they will be discouraged from investing to maintain and upgrade their networks in order to avoid the risk of again being unable to recover embedded costs.[1628] In addition, they argue that they incurred these embedded costs under federal and state regulatory oversight, which imposed on incumbent LECs social policy obligations and uneconomic costing practices, and that

---

[1625] *See, e.g.*, Alaska Tel. Ass'n comments at 4-5; Ameritech comments at 60; Bell Atlantic comments at 36; Cincinnati Bell comments at 30; Lincoln Tel. comments at 11-12; Roseville Tel. comments at 7-8; SBC comments at 59; SNET comments at 29; USTA comments at 40; *see also* NECA comments at 6, reply at 8-9.

[1626] NYNEX comments 54-56, reply at 27.

[1627] USTA comments at 55.

[1628] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Professor Jerry A. Hausman), p.2; Lincoln Tel. comments at 16-17; USTA reply at 23.

they therefore should be permitted to recover them.[1629] Incumbent LECs also assert that past investments were made under the belief that costs would be recovered, and that rates collected in the past did not reflect the risk that embedded costs might not be recovered in future rates.[1630] Several commenters argue that the opportunity to recover embedded costs through rates for interconnection and unbundled elements is particularly important for small and rural incumbent LECs.[1631] Finally, some parties also contend that, if they are not permitted to recover embedded costs, these costs must be recouped elsewhere, thus putting pressure on the states to recover these costs through local rates.[1632]

659. Despite their objections to embedded cost recovery, some non-incumbent parties explain conditions under which some limited recovery should be permitted. For example, MCI argues that, although embedded costs should not be recovered, it would be appropriate to allow incumbent LECs to recover any depreciation reserve deficiency,[1633] which MCI

[1629] *See, e.g.*, Ameritech reply at 30-31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

[1630] *See* Bell Atlantic reply at Exhibit 2 (Declaration of Richard A. Epstein), p.4.

[1631] *E.g.*, Home Tel. comments at 4; NECA comments at 9; TCA comments at 8; Texas Statewide Tel. Cooperative, Inc. comments at 9; Bay Springs reply at 10.

[1632] *See, e.g.*, USTA comments at 56; Wyoming Commission comments at 31-32; *see also* New York Commission reply at 9; *cf.*, Alabama Commission comments at 24-25; Texas Commission comments at 23, 26.

[1633] A reserve imbalance exists when the carrier's actual "book" depreciation reserve differs from its "theoretical" reserve, which is the (continued...)

estimates is only a small percentage of the residual between existing revenues and the revenues generated by a forward-looking, TSLRIC pricing of unbundled network elements.[1634] The Ad Hoc Telecommunications Users Committee asserts that, at a minimum, any nominal losses in economic value attributed to stranded investment should be weighed against the appreciation in value that incumbent LECs have experienced as reflected in share prices and market-to-book ratios.[1635] The Consumer Federation of America proposes that stranded investment might be recovered through an industry-wide recovery fund, if incumbent LECs can satisfy a rigorous set of showings to ensure that ratepayers are fairly treated.[1636] Finally, AT&T argues that, if the Commission determines that some portion of the residual should be recovered, it should be recovered through a competitively neutral, transitional, funding and distribution mechanism that will not distort competition.[1637]

660. *Opportunity Cost -- ECPR.* Incumbent LECs are the primary advocates for ECPR pricing of interconnection and

---

[1633] (...continued)
reserve which would exist if service lives and salvage values had been accurately forecast in the past. When the theoretical reserve exceeds the book reserve, the imbalance is a reserve deficiency. For most LECs the reserve imbalance is an overall deficiency. *Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers*, CC Docket No. 87-447, Report and Order, 3 FCC Rcd 984 (1988).

[1634] *See* MCI comments at 73-75.

[1635] Ad Hoc Telecommunications Users Committee comments at 26-27.

[1636] *See* CFA/CU comments at 67-68.

[1637] *See* AT&T comments at 70-73.

unbundled network elements.[1638] They argue generally that ECPR is the approach that most closely parallels the method a firm in a competitive market would employ when faced with the opportunity of selling inputs to firms that intend to compete with it in its final product market.[1639] GTE asserts that the ECPR's purpose is to reward efficient entry into the market for the end product by ensuring that the incumbent LEC sells network access to itself and to its rivals on the same, nondiscriminatory terms.[1640] Thus, GTE claims, the ECPR sets prices for network elements that provide incentives for efficient entry and compensates incumbent LECs for the economic costs associated with sale of such elements.[1641] GTE further argues that ECPR accomplishes these tasks regardless of the market structure and regardless of the presence or absence of economic rents.[1642] SBC arguesm that the ECPR is equivalent to the avoided cost rule used for setting the prices of resold services and equivalent to the efficient imputation rule for pricing of retail services.[1643] Supporters of ECPR pricing also argue that prices will continue to move toward competitive levels where

---

[1638] *See, e.g.*, Ameritech comments at 91-93; GTE reply at 36-38; MECA comments at 50-52; PacTel comments at 69-71; SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5; *see also* PacTel reply at Appendix C (Declaration of Richard D. Emerson).

[1639] *See, e.g.*, Rural Tel. Coalition reply at 28-30.

[1640] GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.7.

[1641] *Id.* at p.I-i

[1642] *Id.* at p.III-7.

[1643] SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5.

competition is provided by a more efficient carrier than the incumbent LEC.[1644]

661. New entrants and many other commenters oppose the use of the ECPR to set prices for interconnection and access to unbundled network elements.[1645] These parties argue that ECPR does not comply with the statutory mandate that interconnection and network elements be based on costs. They assert that using ECPR would allow incumbent LECs to retain monopoly rents and protect the incumbent LECs from competitive disciplinary market forces.[1646] Opponents of ECPR contend that ECPR pricing does not replicate a competitive environment, but instead perpetuates inefficient and anticompetitive aspects of the current pricing structure. Other commenters argue that the incumbent LECs may use ECPR to exclude or marginalize a more efficient rival in the complementary market by forcing the rival to operate on the higher end of its cost curve through higher interconnection

---

[1644] *See, e.g.*, Ameritech comments at 93; GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.III-6-8.

[1645] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 55; ALTS reply at 26-29; Cable & Wireless comments 35; California Commission reply at 20; CFA/CU comments at 41-45; CompTel reply at 40-49; Cox reply at 29; DoJ reply at 11-13; Frontier comments at 23; Mass. Attorney General comments at 6- 9; MCI comments at 70-71, reply at 16; MFS comments at 60 n.67; Ohio Consumers' Counsel comments at 25 n.7, reply at 15; Sprint comments at 59 n.33; Texas Public Utility Counsel comments at 36; Time Warner comments at 56-58; Telecommunications Resellers Ass'n comments at 41-42; WinStar comments at 41.

[1646] *See, e.g.*, Cable & Wireless comments 35; California Commission reply at 20; CompTel reply at 40; Mass. Attorney General comments at 6-8; Time Warner comments 56-58; Telecommunications Resellers Ass'n comments at 41-42.

charges. They also argue that prices based on ECPR create incentives for incumbent LECs to shift costs of their competitive services to their bottleneck services, which distorts competition.[1647] Finally, opponents of ECPR assert that ECPR pricing shields the largest share of costs possible from competition, preserves the status quo, and imposes a barrier to entry.[1648]

662. Baumol, Ordover, and Willig, principal authors of the theory, explain that ECPR is not applicable for pricing of interconnection and unbundled network elements because the existing end user rates for local telecommunications are not appropriate as a baseline for ECPR. They claim that cross-subsidies are common in the current rates, and rates depart systematically from pertinent costs. Baumol, Ordover, and Willig conclude that applying ECPR to existing rates would result in component prices that lock in the incumbent LECs' monopoly profits and pricing inefficiencies, and would attract inefficient entry, where rates are too high, and would preclude efficient entry where rates are too low.[1649]

663. *Universal Service Subsidies.* Most parties other than incumbent LECs and some state commissions agree that it would be inconsistent with both the cost- based rate requirements of section 252(d)(1) and the requirement in section 254(b)(5), that universal service support mechanisms

---

[1647] *See, e.g.*, N. Economides comments at 4-6.

[1648] *See, e.g.*, CFA/CU comments at 42.

[1649] *See* AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.8-9.

"be specific [and] predictable..."[1650] for states to include any universal service subsidies in the rates they set for interconnection, collocation, and unbundled network elements.[1651] They argue that the 1996 Act requires that rates reflect the economic cost of providing network elements and interconnection and does not authorize subsidies that have nothing to do with economic costs.[1652] With regard to the requirements of section 254, these parties argue that, to the extent rates need to be subsidized for universal service purposes, the subsidy should be collected from all carriers on a non-discriminatory and competitively neutral basis.[1653] The Washington Commission relates its own experience of rejecting US West's request for a per minute universal service charge to cover "carrier of last resort" obligations and its finding that

---

[1650] 47 U.S.C. § 254(b)(5).

[1651] *See, e.g.*, ACTA comments at 23; AT&T comments at 70-73; Competition Policy Institute comments at 20; CompTel comments at 73-74; DoJ comments at 56- 59; MCI comments at 75; NEXTLINK comments at 29; Sprint comments at 61-62; Telecommunications Resellers Ass'n comments at 39 n.76; Teleport comments at 48-49; WinStar comments at 40-41, reply at 13-14.

[1652] AT&T and CompTel further contend that to permit any universal service subsidies in the rates set for interconnection, collocation and unbundled network elements would be to base rates on the embedded costs of incumbent LEC expenditures rather than the forward-looking economic costs of providing a network element as mandated by section 252(d)(1). *See* AT&T comments at 70- 73; CompTel comments at 72-74.

[1653] *See, e.g.*, ACTA comments at 23; AT&T comments at 69; Massachusetts Commission comments at 8-10; MCI comments at 75; Michigan Commission comments at 19.

residential rates were sufficient to cover the costs of residential service.[1654]

664. In contrast, several incumbent LECs and state public utility commissions maintain that incumbent LECs should be permitted to recover their embedded costs in the rates set for interconnection, collocation, and unbundled network elements. These commenters claim that rates based on incremental costs alone fail to account for certain costs historically incurred to accomplish carrier- of-last-resort and universal service social policy objectives.[1655] The Attorneys General caution the Commission not to classify legitimate contributions to joint and common costs as impermissible implicit universal service subsidies.[1656]

665. Several parties comment on the issue of how universal service funding should be handled during the interim period between the effective date of this order and the effective date of the Commission's order implementing the section 254 universal service requirements in May 1997. AT&T proposes that the Commission adopt a competitively-neutral funding and distribution mechanism.[1657] CompTel proposes that the Commission grant a blanket waiver of incremental cost pricing

---

[1654] Washington Commission reply at 6.

[1655] *See, e.g.*, Alabama Commission comments at 24-25; Bay Springs, *et al.* comments at 16; BellSouth comments at 57; Matanuska Tel. comments at 2-3; TDS comments at 20; SBC comments at 89; Western Alliance comments at 6-7; *but see* BellSouth comments at 57 (if the universal service proceeding establishes a federal fund or if the states establish explicit funds, there will be no need for subsidies to be built into interconnection and unbundled network element rates).

[1656] Attorneys General reply at 10-11.

[1657] AT&T comments at 73.

for exchange access. Under CompTel's plan, pending completion of the section 254 proceeding, the incumbent LECs would continue to provide exchange access pursuant to their intrastate and interstate carrier-to- carrier access charge tariffs. At the conclusion of the section 254 proceeding, the Commission would determine whether the incumbent LECs are entitled to recover any portion of those revenues from competitive carriers and, if so, devise appropriate mechanisms for doing so. CompTel asserts that, by preserving the status quo for exchange access until those issues are fully considered and resolved, the Commission would ensure that the 1996 Act does not cause any unnecessary short-term disruption to carriers or consumers.[1658]

666. The Western Alliance contends that states should have authority to order the recovery of lost contribution through access charges until explicit and competitively neutral support mechanisms are in place.[1659] Similarly, the Massachusetts Commission argues that the states should have authority to include universal service subsidies in the rates for interconnection during this period. The Massachusetts Commission further contends that prohibiting states from exercising this authority will promote inefficient competition and ultimately could result in confiscation claims being filed by incumbent LECs.[1660]

667. Some parties take the position that "play or pay" proposals incorporate implicit subsidies into rates for interconnection and unbundled network elements and are

---

[1658] CompTel comments at 84.

[1659] Western Alliance comments at 6-7.

[1660] Mass. Commission comments at 9-10.

therefore inconsistent with the 1996 Act.[1661] They further argue that such programs violate the 1996 Act because they do not require all telecommunications carriers to contribute on an equitable and nondiscriminatory basis and do not qualify as "specific, predictable and sufficient mechanisms" to preserve and advance universal service.[1662]

668. Other commenters argue, however, that the 1996 Act permits reasonable differences in interconnection rates charged to carriers so long as similarly- situated carriers are treated alike. They maintain that the anti- discrimination provisions of the 1996 Act only prohibit unreasonable discrimination. Thus, they contend that "play or pay" schemes are consistent with the 1996 Act.[1663] Several parties also contend that such schemes are authorized by the reservation of state power to adopt and implement universal service measures in section 254.[1664] Moreover, the New York Commission argues that the section 254(e) requirement that universal service funding must be explicit applies only to the federal Universal Service Fund, which is yet to be established, and not to state initiatives.[1665]

669. Some commenters urge the Commission to address universal service in the section 254 proceeding rather

---

[1661] *See, e.g.*, Frontier comments at 23; Teleport comments at 48-49; Texas Public Utility Counsel comments at 35-36; WinStar reply at 14 n.20.

[1662] WinStar comments at 40; *see also* Texas Public Utility Counsel comments at 35.

[1663] *See, e.g.*, New York Commission comments at 15-18; NYNEX comments at 91- 97.

[1664] NYNEX comments at 95-97; New York Commission reply at 6.

[1665] New York Commission reply at 6.

than in the section 251/252 interconnection proceeding.[1666] Other commenters suggest that universal service, access restructure, and interconnection issues should be addressed in a coordinated manner or in a consolidated proceeding.[1667]

670. *Fifth Amendment Issues*. Several incumbent LECs claim that use of a LRIC-based pricing methodology that does not permit recovery of at least joint and common costs and a reasonable profit constitutes unlawful confiscation in violation of the Fifth and Fourteenth Amendments.[1668] Other LECs further argue that, in order to avoid an unconstitutional taking, any pricing rules we adopt must enable them to recover total costs, including historical or embedded costs.[1669] Generally, these parties contend that prices limited by a forward-looking economic cost methodology do not permit an incumbent LEC to remain profitable over time because LRIC fails to recover total costs.[1670] They assert that, if the Commission decides now, long after those costs have been sunk, to bar compensatory returns, it will violate due process and undermine the incumbent LECs' legitimate, investment-

---

[1666] *See, e.g.*, Competition Policy Institute comments at 13-14; F. Williamson comments at 8; Texas Public Utility Counsel comments at 36; ALTS reply at 35.

[1667] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 35; TDS comments at 20.

[1668] *See, e.g.*, GTE comments at 65-71; MECA comments at 42; Puerto Rico Telephone Company reply at 11-12; PacTel comments at 67.

[1669] *See, e.g.*, NYNEX comments at 43-44; PacTel comments at 65-66; SNET comments at 29; Roseville Tel. comments at 6-7.

[1670] *See, e.g.*, Ameritech comments at 62-70; GTE comments at 68-71, reply at 31-32; USTA comments at 39-42.

backed expectations.[1671] Such interference with legitimate investor expectations, they contend, constitutes an unlawful taking.[1672] GTE contends that Commission adoption of a pure TSLRIC methodology would represent an unconstitutional taking, because it would require use of the incumbent LEC's physical property, thus giving rise to an obligation to provide just compensation.[1673]

671. Other parties, including the Department of Justice and new entrants, contend that using a forward-looking cost-based pricing methodology for setting the rates for interconnection and unbundled elements does not constitute an unlawful taking.[1674] These commenters point out that many state commissions already utilize a forward-looking cost-based pricing methodology.[1675] They also argue that, because forward-looking cost-based rates capture all costs for interconnection and unbundled network elements, including the risk-adjusted cost of capital, such a methodology would not result in an unlawful taking.[1676] These parties further assert that the LECs' takings claims are premature, not demonstrated with

---

[1671] *See, e.g.*, GTE comments at 66-71, reply at 31-33; USTA comments at 40- 45, reply at 21-25, 32-34.

[1672] *Id.*

[1673] *See* GTE comments at 65-67.

[1674] *See, e.g.*, ALTS reply at 8-11; AT&T comments at 70-71; CompTel reply at 37-40; DoJ reply at 13, 16-19; MCI reply at 18-20.

[1675] *See, e.g.*, AT&T comments at 49-50; Cable & Wireless reply at 24-25; MCI reply at 19. AT&T also notes that when U S West and BellSouth have been new entrants into markets, they have advocated a LRIC approach. AT&T comments at 50-51 n.72.

[1676] *See, e.g.*, Frontier reply at 14; MCI reply at 18-19.

sufficient specificity, and overstate the scope of the constitutional guarantee.[1677] Commenters note that no incumbent LEC has made any effort to demonstrate the actual impact of a LRIC-based pricing methodology on its "financial integrity."[1678] These parties contend that there is no unconstitutional impairment if the shortfall is not sufficient to jeopardize the operating and financial integrity of the utility. Finally, these commenters maintain that there is no constitutional right to a particular rate-setting methodology (*i.e.*, historical cost) and there are no general principles that require every component of an integral whole of a utility service to show a profit.[1679]

(3) Discussion

672. *Overview.* Having concluded in Section II.D., above, that we have the requisite legal authority and that we should establish national pricing rules, we conclude here that prices for interconnection and unbundled elements pursuant to sections 251(c)(2), 251(c)(3), and 252(d)(1), should be set at forward-looking long-run economic cost. In practice, this will mean that prices are based on the TSLRIC of the network element, which we will call Total Element Long Run Incremental Cost (TELRIC), and will include a reasonable allocation of forward-looking joint and common costs. The 1996 Act encourages competition by removing barriers to entry and providing an opportunity for potential new entrants to purchase unbundled incumbent LEC network elements to

---

[1677] *See, e.g.*, DoJ reply at 16-18.

[1678] DoJ reply at 16-18; MCI reply at 18.

[1679] *See, e.g.*, Jones Intercable reply at 16-17.

compete efficiently to provide local exchange services. We believe that the prices that potential entrants pay for these elements should reflect forward- looking economic costs in order to encourage efficient levels of investment and entry.

673. In this section, we describe this forward-looking, cost-based pricing standard in detail. First, we define the terms we are using, explain how the methodology we are adopting differs from other costing approaches, and describe how it should be implemented. In particular, we explain that the price of a network element should include the forward-looking costs that can be attributed directly to the provision of services using that element, which includes a reasonable return on investment (*i.e.*, "profit"), plus a reasonable share of the forward-looking joint and common costs. Second, we address potential cost measures that must not be included in a TELRIC analysis, such as embedded (or historical) costs, opportunity costs, or universal service subsidies. Finally, we refute arguments that this methodology would violate the incumbent LECs' rights under the Fifth Amendment.

(a) Total Element Long Run Incremental Cost

674. *Definitions of Terms*. In light of the various possible definitions of a number of the critical economic terms used in this context, we begin by defining terms as we use them in this Order. Specifically, we provide definitions for the following terms: "incremental cost;" "economic cost;" "embedded or accounting cost;" "joint cost;" "common cost;" "long run incremental cost;" "total service long run incremental cost;" "total element long run incremental cost." In addition to defining these terms, we explain the economic rationale behind the concepts.

675. Incremental costs are the additional costs (usually expressed as a cost per unit) that a firm will incur as a

result of expanding the output of a good or service by producing an additional quantity of the good or service.[1680] Incremental costs are forward-looking in the sense that these costs are incurred as the output level changes by a given increment.[1681] The costs that are considered incremental will vary greatly depending on the size of the increment. For example, the incremental cost of carrying an additional call from a residence that is already connected to the network to its end office is virtually zero. The incremental cost of connecting a new residence to its end office, however, is the cost of the loop. Forward-looking incremental costs, plus a portion of the forward-looking joint and common costs, are sometimes referred to as "economic costs." Embedded or accounting costs are costs that firms incurred in the past for providing a good or service and are recorded as past operating expenses and depreciation. Due to changes in input prices and technologies, incremental costs may differ from embedded costs of that same increment. In competitive markets, the price of a good or service will tend towards its long-run incremental cost.

676. Certain types of costs arise from the production of multiple products or services. We use the term "joint costs" to refer to costs incurred when two or more outputs are produced in fixed proportion by the same production process (*i.e.*, when one product is produced, a second product is generated by the same production process at no additional cost). The term "common costs" refers to costs that are incurred in connection with the production of multiple products or services,

---

[1680] *See* 1 Alfred Kahn *The Economics of Regulation* 66 (1971); William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

[1681] William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

and remains unchanged as the relative proportion of those products or services varies (*e.g.*, the salaries of corporate managers). Such costs may be common to all services provided by the firm or common to only a subset of those services or elements. If a cost is common with respect to a subset of services or elements, for example, a firm avoids that cost only by not providing each and every service or element in the subset. For the purpose of our discussion, we refer to joint and common costs as simply common costs unless the distinction is relevant in a particular context.

677. The term "long run," in the context of "long run incremental cost," refers to a period long enough so that all of a firm's costs become variable or avoidable.[1682] The term "total service," in the context of TSLRIC, indicates that the relevant increment is the entire quantity of the service that a firm produces, rather than just a marginal increment over and above a given level of production. Depending on what services are the subject of a study, TSLRIC may be for a single service or a class of similar services. TSLRIC includes the incremental costs of dedicated facilities and operations that are used by only the service in question. TSLRIC also includes the incremental costs of shared facilities and operations that are used by that service as well as other services.

678. While we are adopting a version of the methodology commonly referred to as TSLRIC as the basis for pricing interconnection and unbundled elements, we are coining the term "total element long run incremental cost" (TELRIC) to describe our version of this methodology. The incumbent LEC

[1682] *See, e.g.*, William Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977) ("The very long run is a period so long that all of the firm's present contracts will have run out, its present plant and equipment will have been worn out or rendered obsolete and will therefore need replacement, etc.").

offerings to be priced using this methodology generally will be "network elements," rather than "telecommunications services," as defined by the 1996 Act.[1683] More fundamentally, we believe that TELRIC-based pricing of discrete network elements or facilities, such as local loops and switching, is likely to be much more economically rational than TSLRIC-based pricing of conventional services, such as interstate access service and local residential or business exchange service. As discussed in greater detail below, separate telecommunications services are typically provided over shared network facilities, the costs of which may be joint or common with respect to some services. The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are able to provide the other at no additional cost. By contrast, the network elements, as we have defined them,[1684] largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services. Because it is difficult for regulators to determine an economically-optimal allocation of any such joint and common costs, we believe that pricing elements, defined as facilities with associated features and functions, is more reliable from the standpoint of economic efficiency than pricing services that use shared network facilities.

679. *Description of TELRIC-Based Pricing Methodology*. Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent

---

[1683] 47 U.S.C. §§ 3(29), 3(46).

[1684] *See supra* Section V.

possible, the conditions of a competitive market. In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior. Congress recognized in the 1996 Act that access to the incumbent LECs' bottleneck facilities is critical to making meaningful competition possible. As a result of the availability to competitors of the incumbent LEC's unbundled elements at their economic cost, consumers will be able to reap the benefits of the incumbent LECs' economies of scale and scope, as well as the benefits of competition. Because a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace, it allows the requesting carrier to produce efficiently and to compete effectively, which should drive retail prices to their competitive levels. We believe that our adoption of a forward-looking cost-based pricing methodology should facilitate competition on a reasonable and efficient basis by all firms in the industry by establishing prices for interconnection and unbundled elements based on costs similar to those incurred by the incumbents, which may be expected to reduce the regulatory burdens and economic impact of our decision for many parties, including both small entities seeking to enter the local exchange markets and small incumbent LECs.[1685]

680. We note that incumbent LECs have greater access to the cost information necessary to calculate the incremental cost of the unbundled elements of the network. Given this asymmetric access to cost data, we find that incumbent LECs must prove to the state commission the nature and magnitude of any forward-looking cost that it seeks to recover in the prices of interconnection and unbundled network elements.

[1685] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

681. Some parties express concern that the information required to compute prices based on forward-looking costs is inherently so hypothetical as to be of little or no practical value.[1686] Based on the record before us, we disagree. A number of states, which ultimately will have to review forward- looking cost studies in carrying out their duties under section 252, either have already implemented forward-looking, incremental costing methodologies to set prices for interconnection and unbundled network elements or support the use of such an approach.[1687] While these states have applied somewhat different definitions of, and approaches to setting prices developed on, an incremental cost methodology, the record demonstrates that such approaches are practical and implementable.

682. We conclude that, under a TELRIC methodology, incumbent LECs' prices for interconnection and unbundled network elements shall recover the forward- looking costs directly attributable to the specified element, as well as a reasonable allocation of forward-looking common costs. Per-unit costs shall be derived from total costs using reasonably accurate "fill factors" (estimates of the proportion of a facility

---

[1686] *See, e.g.*, GVNW comments at 35; NYNEX comments at 54; USTA comments at 47-50.

[1687] *See, e.g.*, Louisiana Commission comments at 4; Texas Commission comments at 22; Washington Commission comments at 25; California Commission comments at 28-29; Colorado Commission comments at 35; Maryland Commission comments at 7-8; Oklahoma Commission comments at Attachment A (Oklahoma Corporation Commission Telephone Rules, OAC 165:55) pp. 10-11. The Wyoming and Florida commissions have indicated their support for such an approach. *See* Wyoming Commission comments at 27 (supporting uniform use of TSLRIC costing methods so long as details left to states); *see also* Florida Commission comments at 26 (TSLRIC may be appropriate to set cost standard for a price floor).

that will be "filled" with network usage); that is, the per-unit costs associated with a particular element must be derivedby dividing the total cost associated with the element by a reasonable projection of the actual total usage of the element. Directly attributable forward- looking costs include the incremental costs of facilities and operations that are dedicated to the element. Such costs typically include the investment costs and expenses related to primary plant used to provide that element. Directly attributable forward-looking costs also include the incremental costs of shared facilities and operations. Those costs shall be attributed to specific elements to the greatest extent possible.[1688] For example, the costs of conduits shared by both transport and local loops, and the costs of central office facilities shared by both local switching and tandem switching, shall be attributed to specific elements in reasonable proportions. More broadly, certain shared costs that have conventionally been treated as common costs (or overheads) shall be attributed directly to the individual elements to the greatest extent possible. The forward-looking costs directly attributable to local loops, for example, shall include not only the cost of the installed copper wire and telephone poles but also the cost of payroll and other back office operations relating to the line technicians, in addition to other attributable costs.

683. Forward-looking cost methodologies, like TELRIC, are intended to consider the costs that a carrier would incur in the future. Thus, a question arises whether costs should be computed based on the least-cost, most efficient network configuration and technology currently available, or whether forward- looking cost should be computed based on incumbent

---

[1688] *Compare Telephone Company-Cable Television Cross-Ownership Rules*, CC Docket No. 87-266, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 345-46 (1994).

LECs' existing network infrastructures, taking into account changes in depreciation and inflation. The record indicates three general approaches to this issue. Under the first approach, the forward-looking economic cost for interconnection and unbundled elements would be based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry. Prices based on the least-cost, most efficient network design and technology replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represent the least-cost systems available for purchase. This approach, however, may discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network.

684. Under the second approach, the cost of interconnection and unbundled network elements would be based on existing network design and technology that are currently in operation.[1689] Because this approach is not based on a hypothetical network in the short run, incumbent LECs could recover costs based on their existing operations, and prices for interconnection and unbundled elements that reflect inefficient or obsolete network design and technology. This is essentially an embedded cost methodology.

685. Under the third approach, prices for interconnection and access to unbundled elements would be developed from a forward-looking economic cost methodology based on the most efficient technology deployed in the incumbent LEC's current wire center locations. This approach mitigates incumbent LECs' concerns that a forward-looking

---

[1689] *See, e.g.*, BellSouth reply at 37; Roseville Tel. reply at 8; USTA reply at 18-19.

pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent thatnew entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC. We, therefore, conclude that the forward-looking pricing methodology for interconnection and unbundled network elements should be based on costs that assume that wire centers will be placed at the incumbent LEC's current wire center locations, but that the reconstructed local network will employ the most efficient technology for reasonably foreseeable capacity requirements.

686. We agree with USTA, Bell Atlantic, and BellSouth that, as a theoretical matter, the combination of significant sunk investment, declining technology costs, and competitive entry may increase the depreciation costs and cost of capital of incumbent LECs. We do not agree, however, that TSLRIC does not or cannot account for risks that an incumbent LEC incurs because it has sunk investments in facilities. On the contrary, properly designed depreciation schedules should account for expected declines in the value of capital goods. Both AT&T and MCI appear to agree with this proposition.[1690]

[1690] *See* Letter from Leonard S. Sawicki, Director, FCC Affairs, MCI Telecommunications Corp. to William F. Caton, Acting Secretary, FCC, July 24, 1996 at Attachment (Depreciation and Capital Recovery Issues: A Response to Professor Hausman), pp.1-3; *see also* Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to (continued...)

For example, AT&T states, "[i]n order to estimate TSLRIC, one must perform a discounted cash flow analysis of the future costs associated with the decision to invest .... One-time costs associated with the acquisition of capital goods are amortized over the economic life of the assets using the user cost of capital ..., which requires accounting for both expected capital good price changes and economic depreciation."[1691] Moreover, we are confident that parties to an arbitration with TELRIC studies can propose specific depreciation rate adjustments that reflect expected asset values over time.

687. As noted, we also agree that, as a matter of theory, an increase in risk due to entry into the market for local exchange service can increase a LEC's cost of capital. We believe that this increased risk can be partially mitigated, however, by offering term discounts, since long-term contracts can minimize the risk of stranded investment. In addition, growth in overall market demand can increase the potential of the incumbent LEC to use some of its displaced facilities for other purposes. Overall, we think that these factors can and should be captured in any LRIC model and therefore we do not agree that this requires a departure from the general principle of forward- looking cost-based pricing for network elements.

688. We are not persuaded by USTA's argument that forward looking methodologies fail to adjust the cost of capital to reflect the risks associated with irreversible investments and that they are "biased downward by a factor of three." First, USTA's argument unrealistically assumes that competitive

---

[1690] (...continued)
Professor Jerry A. Hausman).

[1691] Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman), p.8.

entry would be instantaneous. The more reasonable assumption of entry occurring over time will reduce the costs associated with sunk investment. Second, we find it unlikely that investment in communications equipment is entirely irreversible or that such equipment would become valueless once facilities-based competition begins. In a growing market, there most likely would be demand for at least some embedded telecommunications equipment, which would therefore retain its value. Third, contractual arrangements between the new entrant and the incumbent that specifically address USTA's concerns and protect incumbent's investments during transition can be established.

689. Finally we are not persuaded that the use by firms of hurdle rates that exceed the market cost of capital is convincing evidence that sunk investments significantly increase a firm's cost of capital. An alternative explanation for this phenomenon is that the process that firms use to choose among investment projects results in overestimates of their returns. Firms therefore use hurdle rates in excess of the market cost of capital to account for these overestimates.[1692]

690. *Summary of TELRIC Methodology.* The following summarizes our conclusions regarding setting prices of interconnection and access to unbundled network elements based on the TELRIC methodology for such elements. The increment that forms the basis for a TELRIC study shall be the

---

[1692] *See* Richard Thaler, *The Winner's Curse*, 2 J. Econ. Perspectives 201 (1988); Keith Brown, *Note on the Apparent Bias of Net Revenue Estimates for Capital Investment Projects*, 29 J. Fin. 1215-16 (1974); Daniel Kahneman and Daniel Lovallo, *Timid Choices, Bold Forecasts*, 39 Management Science 17, 28 (1993). In addition, we note that Hausman's arguments that TSLRIC method underestimate the true cost of an element apply only to the capital expense associated with an element and not to the operating expense.

entire quantity of the network element provided. As we have previously stated, all costs associated with the providing the element shall be included in the incremental cost. Only forward- looking, incremental costs shall be included in a TELRIC study. Costs must be based on the incumbent LEC's existing wire center locations and most efficient technology available.

691. Any function necessary to produce a network element must have an associated cost. The study must explain with specificity why and how specific functions are necessary to provide network elements and how the associated costs were developed. Only those costs that are incurred in the provision of the network elements in the long run shall be directly attributable to those elements. Costs must be attributed on a cost-causative basis. Costs are causally-related to the network element being provided if the costs are incurred as a direct result of providing the network elements, or can be avoided, in the long run, when the company ceases to provide them. Thus, for example, the forward-looking costs of capital (debt and equity) needed to support investments required to produce a given element shall be included in the forward-looking direct cost of that element. Directly attributable costs shall include costs such as certain administrative expenses, which have traditionally been viewed as common costs, if these costs vary with the provision of network elements. Retailing costs, such as marketing or consumer billing costs associated with retail services, are not attributable to the production of network elements that are offered to interconnecting carriers and must not be included in the forward-looking direct cost of an element.

692. In a TELRIC methodology, the "long run" used shall be a period long enough that all costs are treated as

variable and avoidable.[1693] This "long run" approach ensures that rates recover not only the operating costs that vary in the short run, but also fixed investment costs that, while not variable in the short term, are necessary inputs directly attributable to providing the element.

693. States may review a TELRIC economic cost study in the context of a particular arbitration proceeding, or they may conduct such studies in a rulemaking and apply the results in various arbitrations involving incumbent LECs. In the latter case, states must replace any interim rates[1694] set in arbitration proceedings with the permanent rate resulting from the separate rulemaking. This permanent rate will take effect at or about the time of the conclusion of the separate rulemaking and will apply from that time forward.

694. *Forward-Looking Common Costs.* Certain common costs are incurred in the provision of network elements. As discussed above, some of these costs are common to only a subset of the elements or services provided by incumbent LECs. Such costs shall be allocated to that subset, and should then be allocated among the individual elements or services in that subset, to the greatest possible extent. For example, shared maintenance facilities and vehicles should be allocated only to the elements that benefit from those facilities and vehicles. Common costs also include costs incurred by the firm's operations as a whole, that are common to all services and elements (*e.g.*, salaries of executives involved in overseeing all activities of the business), although for the purpose of pricing interconnection and access to unbundled elements,

---

[1693] *See* 1 Alfred E. Kahn *The Economics of Regulation: Principles and Institutions* 70-71 (1988).

[1694] *See infra*, Section VII.C., discussing default proxy price ceilings and ranges.

which are intermediate products offered to competing carriers, the relevant common costs do not include billing, marketing, and other costs attributable to the provision of retail service.[1695] Given these common costs, setting the price of each discrete network element based solely on the forward-looking incremental costs directly attributable to the production of individual elements will not recover the total forward-looking costs of operating the wholesale network.[1696] Because forward-looking common costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements.

695. The incumbent LECs generally argue that common costs are quite significant,[1697] while several other parties maintain that these amounts are minimal.[1698] Because the unbundled network elements correspond, to a great extent, to discrete network facilities, and have different operating characteristics, we expect that common costs should be smaller than the common costs associated with the long-run incremental cost of a service. We expect that many facility costs that may be common with respect to the individual services provided by the facilities can be directly attributed to the facilities when offered as unbundled network elements. Moreover, defining the network elements at a relatively high

---

[1695] *See infra*, Section VIII.B., describing "avoided costs" in the resale context.

[1696] *See, e.g.*, AT&T comments at 61-66; Teleport comments at 47-48.

[1697] *See, e.g.*, PacTel reply at 27-28; *see also* Cincinnati Bell reply at 10; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), p.4 n.1.

[1698] *See, e.g.*, Competition Policy Institute comments at 19; MCI comments at 66; Texas Public Utility Counsel comments at 24.

level of aggregation, as we have done,[1699] should also reduce the magnitude of the common costs. A properly conducted TELRIC methodology will attribute costs to specific elements to the greatest possible extent, which will reduce the common costs. Nevertheless, there will remain some common costs that must be allocated among network elements and interconnection services. For example, at the sub-element level of study (*e.g.*, identifying the respective costs of 2-wire loops, 4-wire loops, ISDN loops, and so on), common costs may be a significant proportion of all the costs that must be recovered from sub-elements. Given the likely asymmetry of information regarding network costs, we conclude that, in the arbitration process, incumbent LECs shall have the burden to prove the specific nature and magnitude of these forward-looking common costs.

696. We conclude that forward-looking common costs shall be allocated among elements and services in a reasonable manner, consistent with the pro- competitive goals of the 1996 Act. One reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs. We conclude that a second reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as the local loop and collocation, that are most difficult for entrants to replicate promptly (*i.e.*, bottleneck facilities). Allocation of common costs on this basis ensures that the prices of network elements that are least likely to be subject to competition are not artificially inflated by a large allocation of common costs. On the other hand, certain other allocation methods would not be reasonable. For example, we conclude that an allocation methodology that relies exclusively on allocating common

---

[1699] *See supra*, Section V., discussing unbundling requirements.

costs in inverse proportion to the sensitivity of demand for various network elements and services may not be used.[1700] We conclude that such an allocation could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the prices of, the most critical bottleneck inputs, the demand for which tends to be relatively inelastic. Such an allocation of these costs would undermine the pro-competitive objectives of the 1996 Act.

697. We believe that our treatment of forward-looking common costs will minimize regulatory burdens and economic impact for all parties involved in arbitration of agreements for interconnection and access to unbundled elements, and will advance the 1996 Act's pro-competitive objectives for local exchange and exchange access markets.[1701] In our decisionmaking, we have considered the economic impact of our rules in this section on small incumbent LECs. For example, although opposed to the use of a forward-looking, economic cost methodology, small incumbent LECs favor the recovery of joint and common costs in the event the Commission adopts forward-looking cost methodology. We are adopting such an approach. Moreover, the cost-based pricing methodology that we are adopting is designed to permit incumbent LECs to recover their economic costs of providing interconnection and unbundled elements, which may minimize

---

[1700] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991). The sensitivity of demand is measured by the elasticity of demand, which is defined as the percentage change in the quantity of a service demanded for a one per cent change in price.

[1701] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

the economic impact of our decisions on incumbent LECs, including small incumbent LECs. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1702]

698. We further conclude that, for the aggregate of all unbundled network elements, incumbent LECs must be given a reasonable opportunity to recover their forward-looking common costs attributable to operating the wholesale network. In no instance should prices exceed the stand-alone cost for a specific element, and in most cases they should be below stand-alone costs. Stand-alone costs are defined as the forward-looking cost that an efficient entrant would incur in providing a given element or any combination of elements. No price higher than stand-alone cost could be sustained in a market from which entry barriers were completely absent. Where there are few common costs, there is likely to be only a minimal difference between the forward- looking costs that are directly attributable to the particular element, which excludes these costs, and stand-alone cost, which includes all of them. Network elements should not, however, be priced at levels that would enable the incumbent LEC to recover the same common costs multiple times from different elements. Any multiple recovery would be unreasonable and thus in violation of the statutory standard. Further, we note that the sum of the direct costs and the forward-looking common costs of all elements will likely differ from the incumbent LEC's historical, fully distributed costs.

[1702] 47 U.S.C. § 251(f).

699. *Reasonable Return on Investment and "Profit."* Section 252(d)(1) states that rates for interconnection and access to unbundled elements "may include a reasonable profit."[1703] We find that the TELRIC pricing methodology we are adopting provides for such a reasonable profit and thus no additional profit is justified under the statutory language. We note there are two types of profit. First, in plain English, profit is defined as "the excess of returns over expenditure in a transaction or a series of transactions."[1704] This is also known as a "normal" profit, which is the total revenue required to cover all of the costs of a firm, including its opportunity costs.[1705] Second, there is "economic" profit, which is any return in excess of normal profit.[1706] Thus, for example, if the normal return in an industry is 10 percent and a firm earns a return of 14 percent, the economic profit for that firm is 4 percent. Economic is also referred to as "supranormal" profit. We conclude that the definition of "normal" profit is embodied in "reasonable profit" under Section 252(d)(1).

700. The concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements. This forward-looking cost of capital is equal to a normal profit. We conclude that allowing greater than normal profits would not be "reasonable" under sections 251(c) and

---

[1703] 47 U.S.C. § 252(d)(1).

[1704] *Webster's New Collegiate Dictionary* 931 (10th ed. 1994).

[1705] *See* David W. Pearce, *The MIT Dictionary of Modern Economics* (1994) at 310.

[1706] *Id.* at 415.

252(d)(1).[1707] Thus, contrary to the arguments put forth by several incumbent LECs, we find that adding an additional measure of profit to the risk-adjusted cost of capital[1708] in setting the prices for interconnection and access to unbundled

---

[1707] We note that our interpretation is consistent with existing Supreme Court precedent concerning what constitutes a reasonable rate of return for a regulated public utility. For example, in *Bluefield Water Works*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.

Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923). Similarly, in *FPC v. Hope Natural Gas*, the Court stated:

> ... it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock ...By that standard the return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1994) *(Hope Natural Gas)*. *Cf.*, Charles F. Phillips, Jr., *The Economics of Regulation* 260 (Rev. Ed. 1965)("...a regulated company must be afforded the opportunity not only of assuring its financial integrity so that it can maintain its credit standing and attract additional capital as needed, but also for earnings comparable to those of other companies having corresponding risks.")

[1708] *See supra*, this Section, for a discussion of risk-adjusted cost of capital.

elements would violate the requirements of sections 251(c) and 252(d)(1) of the 1996 Act.

701. Possible accounting losses from the sale of interconnection and unbundled network elements using a reasonable forward-looking cost-based methodology do not necessarily indicate that incumbent LECs are being denied a "reasonable profit" under the statute. The use of a forward-looking, economic, cost-based pricing methodology, including a reasonable allocation of legitimate joint and common costs, will permit incumbent LECs the opportunity to earn a reasonable return on their investment in network elements. Finally, contrary to PacTel's argument, and as discussed below in detail, we conclude that our forward-looking cost-based pricing methodology is consistent with the Fifth Amendment and is not confiscatory.

702. Based on the current record, we conclude that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk- adjusted cost of capital or depreciation rate. These elements generally are bottleneck, monopoly services that do not now face significant competition. We recogniz that incumbent LECs are likely to face increased risks given the overall increases in competition in this industry, which generally might warrant an increased cost of capital, but note that, earlier this year, we instituted a preliminary inquiry as to whether the currently authorized federal 11.25 percent rate of return is too high given the current marketplace cost of equity

and debt.[1709] On the basis of the current record, we decline to engage in a time-consuming examination to determine a new rate of return, which may well require a detailed proceeding. States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted, without that commission conducting a "rate-of-return or other rate based proceeding."[1710] We note that the risk-adjusted cost of capital need not be uniform for all elements. We intend to re-examine the issue of the appropriate risk-adjusted cost of capital on an ongoing basis, particularly in light of the state commissions' experiences in addressing this issue in specific situations.

703. We disagree with the conclusion that, when there are mostly sunk costs, forward-looking economic costs should not be the basis for pricing interconnection elements. The TELRIC of an element has three components, the operating expenses, the depreciation cost,[1711] and the appropriate risk-adjusted cost of capital. We conclude that an appropriate calculationof TELRIC will include a depreciation rate that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor. Thus, even in the presence of sunk costs, TELRIC-based prices are an appropriate pricing methodology.

[1709] *See Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry*, Public Notice, 11 FCC Rcd 3651 (Com. Car. Bur. 1996).

[1710] 47 U.S.C. § 252(d)(1)(A)(i).

[1711] Depreciation is the method of recognizing as an expense the cost of a capital investment. Properly calculated economic depreciation is a periodic reduction in the book value of an asset that makes the book value equal to its economic or market value.

(b) Cost Measures Not Included in Forward-Looking Cost Methodology

704. *Embedded Costs.* We read section 252(d)(1)(A)(i) to prohibit states from conducting traditional rate-of-return or other rate-based proceedings to determine rates for interconnection and access to unbundled network elements. We find that the parenthetical, "(determined without reference to a rate-of- return or other rate-based proceeding),"[1712] does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the cost of interconnection and unbundled network elements. The legislative history demonstrates that Congress was eager to set in motion expeditiously the development of local competition and intended to avoid imposing the costs and administrative burdens associated with a traditional rate case. Prior to the joint conference, the Senate version of the 1996 Act contained the parenthetical language.[1713] In addition, the Senate version of the 1996 Act eliminated rate-of-return regulation,[1714]

[1712] 47 U.S.C. § 252(d)(1)(A)(i).

[1713] S. 652, 104th Cong., 1st Sess. s 251(d)(6)(A) (1995) ("the charge (A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the unbundled element ....").

[1714] *Id.* at s 301(a)(3) ("Rate of Return Regulation Eliminated -- (A) In instituting the price flexibility required under paragraph (1) the Commission and the States shall establish alternative forms of regulation for Tier 1 telecommunications carriers that do not include regulation of the rate of return earned by such carrier....").

as did the House version.[1715] Conferees removed the provisions eliminating rate-of-return regulation, but retained the parenthetical.

705. Section 252(d)(1)(A)(i) does not specify whether historical or embedded costs should be considered or whether only forward-looking costs should be considered in setting arbitrated rates. We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes the prices for interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a price based on forward looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an "embedded cost"-based pricing methodology would be pro-competitor -- in this case the incumbent LEC -- rather than pro-competition.[1716] We therefore decline to adopt

---

[1715] H.R. 1555, 104th Cong., 1st Sess. s 248(b) (1995) ("Abolition of Rate-of-Return Regulation -- Notwithstanding any other provision of law, to the extent that a carrier has complied with sections 242 and 244 of this part, the Commission, with respect to rates for interstate or foreign communications, and State commissions, with respect to rates for intrastate communications, shall not require rate-of-return regulation.").

[1716] *See, e.g.*, Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p.4; ALTS comments at Attachment B (Competitive Pricing of Interconnection, Unbundled Elements, and Collocation), pp.28-29; AT&T reply at Appendix B (Reply Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.3-5; Competition Policy Institute (continued...)

embedded costs as the appropriate basis of setting prices for interconnection and access to unbundled elements. Rather, we reiterate that the prices for the interconnection and network elements critical to the development of a competitive local exchange should be based on the pro- competition, forward-looking, economic costs of those elements, which may be higher or lower than historical embedded costs. Such pricing policies will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act, which should minimize the regulatory burdens and economic impact of our decisions on small entities.[1717]

706. Incumbent LECs contend generally that, in order to ensure they will recover their total investment costs and earn a profit, they must recover embedded costs. These costs, they argue, were incurred under federal and regulatory oversight and therefore should be recoverable.[1718] We are not convinced by the incumbent LECs' principal arguments for recognizing embedded cost in setting section 251 pricing rules. Even if the incumbent LECs' contention is correct, increasing the rates for interconnection and unbundled elements offered to competitors would interfere with the development of efficient competition, and is not the proper remedy for any past under- depreciation. Moreover, contrary to assertions bysome incumbent LECs, regulation does not and should not guarantee full recovery of their embedded costs. Such a guarantee would exceed the

---

[1716] (...continued)
comments at 18-19; DJ comments at 30-31.

[1717] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1718] *See, e.g.*, Ameritech reply at 31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

assurances that we or the states have provided in the past.[1719] We have considered the economic impact of precluding recovery of small incumbent LECs' embedded costs.[1720] We do not believe that basing the prices of interconnection and unbundled elements on an incumbent LEC's embedded costs would advance the pro-competitive goals of the statute. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1721]

707. We acknowledge that some incumbent LECs may have incurred certain embedded costs reasonably before the passage of the 1996 Act, based on different regulatory regimes. Some incumbent LECs may assert that they have made certain historical investments required by regulators that they have been denied a reasonable opportunity to recover in the past and that the incumbent LECs may no longer have a reasonable opportunity to recover in the new environment of the 1996 Act. The record before us, however, does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at economic costs. To the extent that any such residual consists of costs of meeting universal service obligations, the recovery of such costs can and should be considered in our ongoing

---

[1719] *See In the Matter of the Applications of Pacific Bell*, Order and Authorization, 10 FCC Rcd 12448, 12502-12503 (1995).

[1720] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq*.

[1721] 47 U.S.C. § 251(f).

universal service proceeding.[1722] To the extent a significant residual exists within the interstate jurisdiction that does not fall within the ambit of section 254, we intend that to address that issue in our upcoming proceeding on access reform.

708. *Opportunity Cost -- Efficient Component Pricing Rule*. A number of incumbent LECs advocate using the "efficient component pricing rule" (ECPR) to set the prices that incumbent LECs charge new entrants for inputs required to produce the same retail services the incumbent produces. Under the ECPR, the price of an input should be equal to the incremental cost of the input plus the opportunity cost that the incumbent carrier incurs when the new entrant provides the services instead of the incumbent. The opportunity cost, which is computed as revenues less all incremental costs, represents both profit and contribution to common costs of the incumbent, given the existing retail prices of the services being sold.

709. We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based. Moreover, the ECPR does not provide any mechanism for moving prices towards competitive levels; it simply takes prices as given. The record indicates that both incumbents and new entrants agree that retail prices are not based on costs. Incumbents generally argue that local residential retail prices are below costs while new entrants contend that they exceed competitive levels.[1723] In either case, application of ECPR would result in input prices that would be either higher or lower than those which would be generated in

---

[1722] *See Universal Service* NPRM at para. 32.

[1723] *See, e.g.*, Ameritech comments at 62.

a competitive market and would not lead to efficient retail pricing.

710. In markets where retail prices exceed competitive levels, entry would take place if network element prices were set at efficient competitive levels. The ECPR, however, will serve to discourage competition in these very markets because it relies on the prevailing retail price in setting the price which new entrants pay the incumbent for inputs. While ECPR establishes conditions for efficient entry given existing retail prices, as its advocates contend, the ECPR provides no mechanism that will force retail prices to their competitive levels. We do not believe that Congress envisioned a pricing methodology for interconnection and network elelments that would insulate incumbent LECs' retail prices from competition. Instead, Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore, we reject the use of ECPR for establishing prices for interconnection and unbundled elements.

711. As discussed above, the record in this docket shows that end user prices are not cost-based. In *Open Video Systems*, in contrast, we did not find that there would be a problem with the determination of end user prices.[1724] We concluded that "[u]se of [an ECPR] approach is appropriate in circumstances where the pricing is applicable [sic] to a new market entrant (the open video system operator) that will face competition from an existing incumbent provider (the incumbent cable operator), as opposed to circumstances where the pricing is used to establish a rate for an essential input service that is charged to a competing new entrant by an

---

[1724] *Implementation of Section 302 of the Telecommunications Act of 1996 -- Open Video Systems*, CS Docket No. 96-46, Second Report and Order, FCC 96-249 (rel. June 3, 1996) *(Open Video Systems)*.

incumbent provider."[1725] In addition, in *Open Video Systems*, we concluded that the ECPR is appropriate because it encourages entry for open video system operators and also enhances the availability of carriage for unaffiliated programmers.[1726] The ECPR generally protects the provider's profits and provides opportunities for third parties to use the provider's inputs. The ECPR does not provide a mechanism to drive retail prices to competitive levels, however. In *Open Video Systems*, we wanted to encourage entry by open video system providers and to encourage them to have incentives to open their systems to unaffiliated programmers. Here, our goal is to ensure that competition between providers, including third party providers using interconnection and unbundled elements, will drive prices toward competitive levels and thus use of the ECPR is inappropriate.

712. *Universal Service Subsidies*. We conclude that funding for any universal service mechanisms adopted in the universal service proceeding may not be included in the rates for interconnection, network elements, and access to network elements that are arbitrated by the states under sections 251 and 252. Sections 254(d) and 254(e) of the 1996 Act mandate that universal service support be recovered in an equitable and nondiscriminatory manner from all providers of telecommunications services.[1727] We conclude that permitting states to include such costs in rates arbitrated under sections 251 and 252 would violate that requirement by requiring

---

[1725] Id at 127.

[1726] *Id.*

[1727] Joint Explanatory Statement at 131 ("In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit ...").

carriers to pay specified portions of such costs solely because they are purchasing services and elements under section 251. Section 252(d)(1) requires that rates for interconnection, network elements, and access to network elements reflect the costs of providing those network elements, not the costs of supporting universal service.

713. Section 254(f) provides that a state may adopt equitable, nondiscriminatory, specific, and predictable mechanisms to advance universal service within that state.[1728] If a state collects universal service funding in rates for elements and services pursuant to sections 251 and 252, it will be imposing non-cost based charges in those rates. Including non-cost based charges in the rates for interconnection and unbundled elements is inconsistent with our rules implementing sections 251 and 252 which require that these rates be cost-based. It is also inconsistent with the requirement of section 254(f) that telecommunications carriers contribute to state universal service on a nondiscriminatory basis, because telecommunications carriers requesting interconnection or access to unbundled network elements will be required to make contributions to universal service support through such surcharges.[1729] States may not, therefore, include universal service support funding in the rates for elements and services pursuant to sections 251 and 252, nor may they implement mechanisms that have the same effect. For example, states may not fund universal service support by imposing higher rates for interconnection, unbundled elements, or transport and termination on carriers that offer service to different types of customers or different geographic areas. To the extent that New York's "pay or play" system funds universal service in this

[1728] 47 U.S.C. § 254(f).

[1729] *See infra*, Section VII.D.3., discussing discrimination.

manner, it violates sections 251, 252, and 254 of the 1996 Act. Nothing in the 1996 Act or in this Order, however, precludes a state from adopting a universal service funding mechanism, whether interim or otherwise, if such funds are collected in accordance with section 254(f) on an "equitable and nondiscriminatory basis" through "specific, predictable, and sufficient mechanisms that do not rely on or burden Federal universal service support mechanisms."[1730]

714. Our decision here does not exempt carriers purchasing elements or services under section 251 from contributing to (or possibly receiving) universal service support. Rather, the recovery of universal service support costs from telecommunications carriers, including carriers requesting unbundled network elements, will be governed by section 254 of the 1996 Act. Federal universal service support mechanisms will be determined by our decisions reached in CC Docket 96-45, based on the recommendations of the Federal/State Universal Service Joint Board, and states may adopt additional universal service support mechanisms consistent with section 254(f).

715. We are mindful that the requirements of the 1996 Act may be disruptive to existing state universal service support mechanisms during the period commencing with this order and continuing until we complete our universal service proceeding to implement section 254. As discussed in the subsection immediately below, we permit incumbent LECs to continue to recover certain non- cost-based interstate access charge revenues for a limited period of time, largely because of concerns about possible deleterious impacts on universal service. We also authorize incumbent LECs, for a similar limited period of time, to continue to recover explicit intrastate

[1730] 47 U.S.C. § 254(f).

universal service subsidy revenues based on intrastate access charges. This mechanism minimizes any possibility that implementation of sections 251 and 252 will unduly harm universal service during the interim period prior to completion of our universal service and access reform proceedings. Because we conclude this action should adequately provide for the continuation of a portion of existing subsidy flows during a transition period until completion of our proceeding implementing section 254, we decline to permit any additional funding of universal service support through rates for interconnection, unbundled elements, and transport and termination during the interim period.

716. *Interim Application of Access Charges to Purchasers of Unbundled Local Switching Element.* In the introduction of this Order, we emphasize that implementation of section 251 of the 1996 Act is integrally related to both universal service reform as required under section 254, and to reform of the interstate access charge system.[1731] In order to achieve pro-competitive, deregulatory markets for all telecommunications services, we must create a new system of funding universal service that is specific, explicit, predictable, sufficient, and competitively neutral. We also must move access charges to more cost-based and economically efficient levels. We intend to fulfill both of these goals in the coming months, by completing our pending universal service proceeding to implement section 254 by our statutory deadline of May 1997, and by addressing access charge issues in an upcoming access reform proceeding. The 1996 Act, however, requires us to adopt rules implementing section 251 by August 1996. We are concerned that implementation of the requirements of section 251 now, without taking into account

[1731] *See supra*, Section I.B.

the effects of the new rules on our existing access charge and universal service regimes, may have significant, immediate, adverse effects that were neither intended nor foreseen by Congress.

717. Specifically, as we conclude above, the 1996 Act permits telecommunications carriers that purchase access to unbundled network elements from incumbent LECs to use those elements to provide telecommunications services, including the origination and termination of interstate calls. Without further action on our part, section 251 would allow entrants to use those unbundled network facilities to provide access services to customers they win from incumbent LECs, without having to pay access charges to the incumbent LECs. This result would be consistent with the long term outcome in a competitive market. In the short term, however, while other aspects of our regulatory regime are in the process of being reformed, such a change may have detrimental consequences.

718. The access charge system includes non-cost-based components and elements that at least in part may represent subsidies, such as the carrier common line charge (CCLC) and the transport interconnection charge (TIC). The CCLC recovers part of the allocated interstate costs for incumbent LECs to provide local loops to end users. In the universal service NPRM, we observed that the CCLC may result in higher-volume toll users paying rates that exceed cost, and some customers paying rates that are below cost. We sought comment on whether that subsidy should be continued, and on whether and how it should be restructured.[1732] The nature of most of the revenues recovered through the TIC is unclear and subject to dispute, although a portion of the TIC is associated with certain costs related to particular transport

[1732] *Universal Service* NPRM at paras. 113-14.

facilities. Although the TIC was not created to subsidize local rates, some parties have argued in the *Transport* proceeding and elsewhere that some portion of the revenues now recovered through the TIC may be misallocated local loop or intrastate costs that operate to support universal service.[1733] In the forthcoming access reform proceeding, we intend to consider the appropriate disposition of the TIC, including the development of cost-based transport rates as directed by the United States Court of Appeals for the District of Columbia Circuit in *Competitive Telecommunications Association v. FCC* (*CompTel v. FCC*).[1734]

719. Without a temporary mechanism such as the one we adopt below, the implementation of section 251 would permit competitive local service providers that also provide interstate long-distance service to avoid totally the CCLC and the TIC, which in part represent contributions toward universal service, by serving their local customers solely through the use of unbundled network elements rather than through resale. We believe that allowing such a result before we have reformed our universal service and access charge regimes would be undesirable as a matter of both economics and policy, because carrier decisions about how to interconnect with incumbent LECs would be driven by regulatory distortions in our access charge rules and our universal service scheme, rather than the

---

[1733] *Transport Rate Structure and Pricing,* CC Docket No. 91-213, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7065-7066 (1992) *(First Transport Order). Cf.* Letter from Bruce K. Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, September 7, 1995 (filed in CC Docket No. 91-213) (suggesting that TIC revenues not allocable to specific transport facilities may represent misallocated common line costs).

[1734] *Competitive Telecommunications Association v. FCC,* No. 96-1168 (D.C. Cir. July 5, 1996).

unfettered operation of a competitive market. Because of our desire to err on the side of caution where universal service may be implicated, we conclude that some action is needed during the interim period before we complete our access reform and universal service proceedings.

720. We conclude that we should establish a temporary transitional mechanism to help complete all of the steps toward the pro-competitive goal of the 1996 Act, including the implementation of a new, competitively-neutral system to fund universal service and a comprehensive review of our system of interstate access charges. Therefore, for a limited period of time, incumbent LECs may recover from interconnecting carriers the CCLC and a charge equal to 75 percent of the TIC for all interstate minutes traversing the incumbent LECs' local switches for which the interconnecting carriers pay unbundled local switching element charges. Incumbent LECs may recover these charges only until the earliest of: (1) June 30, 1997; (2) the effective date of final decisions by the Commission in both the universal service and access reform proceedings; or (3) if the incumbent LEC is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. The end date for BOCs that are authorized to offer interLATA service shall apply only to the recovery of access charges in those states in which the BOC is authorized to offer such service.

721. We tentatively concluded in the NPRM that purchasers of unbundled network elements should not be required to pay access charges. We reaffirm our conclusion above in our discussion of unbundled network elements that nothing on the face of sections 251(c)(3) and 252(d)(1) compels telecommunications carriers that use unbundled elements to pay these charges, nor limits these carriers' ability to use unbundled elements to originate or terminate interstate calls, and that

payment of rates based on TELRIC plus a reasonable allocation of common costs, pursuant to section 251(d)(1), represents full compensation to the incumbent LEC for use of the network elements that telecommunications carriers purchase. Because of the unique situation described in the preceding paragraphs, however, we conclude, contrary to our proposal in the NPRM, that during a time-limited period, interconnecting carriers should not be able to use unbundled elements to avoid access charges in all cases. As detailed below, this temporary mechanism will apply only to carriers that purchase the local switch as an unbundled network element, and use that element to originate or terminate interstate traffic.[1735] We are applying these transitional charges to the unbundled local switching element, rather than to any other network elements, because such an approach is most closely analogous to the manner in which the CCLC and TIC are recovered in the interstate access regime. Currently, the CCLC and TIC apply to interstate switched access minutes that traverse incumbent LECs' local switches. Applying the CCLC and 75 percent of the TIC to the unbundled local switching element is consistent with our goal of minimizing disruptions while we reform our universal service system and consider changes to our access charge mechanisms. Moreover, the CCLC and the TIC are recovered on a per-minute basis, and the local switch is the primary point at which incumbent LECs are capable of recording interstate minutes for traffic associated with end user customers of requesting carriers.

722. We have crafted this short-term continuation of certain access charge revenue flows to minimize the possibility

---

[1735] As discussed *infra*, carriers that choose to enter a local market through resale of an incumbent LEC's intrastate local exchange service will pay interstate and intrastate access charges to originate and terminate toll traffic for end user customers that purchase that resold local exchange service.

that incumbent LECs will be able to "double recover" through access charges the facility costs that new entrants have already paid to purchase unbundled elements. For that reason, we do not permit incumbent LECs to assess on purchasers of the unbundled local switching element any interstate access charges other than the CCLC and 75 percent of the TIC. The other access charges are all designed to recover the cost of particular facilities involved in the provision of interstate access services, such as local switching, dedicated interoffice transport circuits, and tandem switching. Imposition of these facility-based access charges in addition to the cost-based charges for comparable network elements established under Section 252 could result in double recovery. The mechanism we establish will ensure that incentives created by non-cost-based elements of access charges do not result in harmful consequences prior to completion of access reform and our universal service proceeding. Imposition of additional access charges is therefore not necessary. We note that this mechanism serves to minimize the potentially disruptive effects of our decisions on incumbent LECs, including small incumbent LECs.[1736]

723. For the same reason, we permit incumbent LECs to recover only 75 percent of the TIC. Some portion of the TIC recovers revenues associated with specific transport facilities. To the extent that these costs can be identified clearly, they should not be imposed on new entrants through the TIC. Incumbent LECs will be fully compensated for any transport facilities that new entrants purchase from them through the unbundled element rates states establish under 252(d)(1), which, as we have stated, must be based on economic cost rather than access charges. In our interim transport rate restructuring, we explicitly set the initial tandem switching rate

---

[1736] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

at 20 percent of the interstate revenue requirement, with the remainder included in the TIC.[1737] In addition, certain costs of upgrading incumbent LEC networks to support SS7 signaling were allocated to transport through then-existing separations procedures. In our interim transport rate restructuring, we did not create any facility-based charges to recover these costs,[1738] so the associated revenues presumably were incorporated into the TIC. There may also be other revenues associated with transport facilities that are recovered today through the TIC. While we are uncertain of the precise magnitude of these revenues, in our best judgment, based on the record in the *Transport* proceeding and other information before us, we find that it is likely that these revenues approach, but probably do not exceed 25 percent of the TIC for most incumbent LECs. Thus, we believe that 25 percent is a conservative amount to exclude from the TIC to ensure that incumbent LECs do not double recover revenues associated with transport facilities from new entrants. Moreover, the Court in *CompTel v. FCC* remanded our *Transport* decision, in part, because of the inclusion of tandem switching revenues in the TIC rather than in the rate element for tandem switching. We find that excluding 25 percent of the TIC represents a reasonable exercise of our discretion to prevent revenues associated with the tandem switching revenue requirement from being recovered from purchasers or unbundled local switching.

724. We strongly emphasize that these charges will apply to purchasers of the unbundled switching element only for a very limited period, to avoid the possible harms that might arise if we were to ignore the effects on access charges and universal service of implementation of section 251. BOCs shall

---

[1737] *First Transport Order*, 7 FCC Rcd at 7019.

[1738] *First Transport Order*, 7 FCC Rcd at 7019.

not be permitted to recover these revenues once they are authorized to offer in- region interLATA service, because at that time the potential loss of access charge revenues faced by a BOC most likely will be able to be offset by new revenues from interLATA services. Moreover, although we do not prejudge the conditions necessary to grant BOC petitions under section 271 to offer in- region interLATA service, we do decide that BOCs should not be able to charge the CCLC and the TIC, which are not based on forward-looking economic costs, to competitors that use unbundled elements under section 251 once they are authorized to provide in-region interLATA service. Only BOCs are subject to special restrictions in the 1996 Act to ensure that their entry into the in- region interLATA market does not have an adverse impact on competition. We conclude that this additional trigger date after which BOCs may not continue to receive access charges from purchasers of unbundled local switching is consistent with this Congressional design.

725. We have selected June 30, 1997 as an ultimate end date for this transitional mechanism to coincide with the effective date for LEC annual access tariffs, and because we believe it is imperative that this transitional requirement be limited in duration. We can conceive of no circumstances under which the requirement that certain entrants pay the CCLC or a portion of the TIC on calls carried over unbundled network elements would be extended further. The fact that access or universal service reform have not been completed by that date would not be a sufficient justification, nor would any actual or asserted harm to the financial status of the incumbent LECs. By June 30, 1997, the industry will have had sufficient time to plan for and adjust to potential revenue shifts that may result from competitive entry. Thus, the economic impact of our decision

on competitive local service providers, including those that are small entities, should be minimized.[1739]

726. We believe that we have ample legal authority to implement this temporary transitional measure, and we find that this approach is consistent with the letter and spirit of the 1996 Act. We recognize that the CCLC and TIC have not been developed in accordance with the pricing standards of section 252(d)(1), and that to comply with the 1996 Act, the rates that states establish for interconnection and unbundled network elements may not include non-cost-based amounts or subsidies. The 1934 and 1996 Acts do, however, give us legal authority to determine, for policy reasons, that users of LEC facilities should pay certain access charges for a period of time.[1740] Section 4(i) of the 1934 Act authorizes the Commission to "perform any and all acts ... not inconsistent with this Act, as may be necessary in the execution of its functions."[1741] Given the extraordinary upheaval in the industry's structure set in motion by the 1996 Act, and the specific concerns described above, we believe that a temporary mechanism is necessary in order to ensure that the policy goals underlying the access charge system and the Communications Act itself are not undermined. Further, we believe section 251(g) of the 1996 Act lends support to our decision. As discussed above, section 251(g) does not require that incumbent LECs continue to receive access charge revenues when telecommunications

---

[1739] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1740] *See, e.g., New England Tel. and Tel. Co. v. FCC*, 826 F.2d 1101 (D.C. Cir 1987); *North American Telecommunications Association v. FCC*, 772 F.2d (7th Cir. 1085); *Lincoln Tel. and Tel. Co. v. FCC*, 659 F.2d (D.C. Cir. 1989).

[1741] 47 U.S.C. § 4(i).

carriers use unbundled incumbent LEC network elements to originate and terminate interstate traffic. That section does, however, provide evidence of Congressional recognition of the potential tension between existing interconnection obligations, such as access charges, and the new methods of interconnection mandated by section 251, and therefore supports our decision to create a limited-duration mechanism to address this tension.

727. The decision of the court in *CompTel v. FCC* to remand our decision to adopt the TIC is not inconsistent with this approach. The Court's concern stemmed, in part, from the inclusion of a portion of the interstate tandem switching revenue requirement in the TIC. We have excluded from the charges that purchasers of unbundled local switching must pay a percentage of the TIC that, at a minimum, includes these allocated tandem switching revenues from the transitional charges that incumbent LECs may assess on IXCs.[1742] Furthermore, the Court directed the Commission to develop a cost-based transport rate structure, or to explain why it chose not to do so.[1743] We intend to fulfill this obligation in the forthcoming access reform proceeding. The charge equal to 75 percent of the TIC will be applied only as an interim measure for a brief, clearly-identified period, until that restructuring of access charges is completed. The court expressly acknowledged that the 1996 Act would have implications for the access charge system.[1744] For the reasons described above,

---

[1742] As discussed above, we estimate that the tandem switching, SS7, and other costs associated with transport facilities now recovered through the TIC likely do not exceed 25% of the TIC for most incumbent LECs.

[1743] *Competitive Telecommunications Association v. FCC*, No. 96-1168 at 26- 27.

[1744] Id at 12-13.

we conclude that these effects necessitate temporary application of a portion of the TIC to entrants that win end user customers from LECs, and that purchase the local switch as an unbundled element to originate and terminate interstate and intrastate toll traffic for such end users. In the access reform proceeding, we intend to determine the appropriate disposition for these revenues. Until we have had the opportunity to do so, however, we permit incumbent LECs to recover a transitional charge equal to 75 percent of the TIC under the limited circumstances described herein.

728. The interim mechanism we establish here differs from the waiver relief we have previously granted to NYNEX and Ameritech to permit them to recover certain interstate access charge revenues through "bulk billing" of revenues to all interstate switched access customers.[1745] Those orders responded to waiver requests filed prior to the passage of the 1996 Act. Our responsibility in those proceedings was to determine whether special circumstances existed, and whether the specific relief requested better served the public interest than continued application of our general rules. By contrast, the action we take today addresses industry-wide issues that arise from the new regime put into place by section 251 of the 1996 Act, which allows states to establish unbundled network element rates that recover the full unseparated cost of elements. Our response to the Ameritech and NYNEX waiver petitions

---

[1745] *See The NYNEX Tel. Cos. Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment,* Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995), *reconsideration pending (NYNEX USPP Order); Ameritech Operating Companies Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region,* Order, FCC 96-58 (released Feb. 15, 1996) *(Ameritech Customers First Order).*

does not, simply because those petitions also concerned access charge recovery, constrain our decision in this proceeding.

729. It would be unreasonable to provide such a transitional mechanism on the federal level, but to deny similar authority to the states. Therefore, states may continue existing explicit universal service support mechanisms based on intrastate access charges for an interim period of a similar brief, clearly- defined length. During that period, unless decided otherwise by the state, incumbent LECs may continue to recover such revenues from purchasers of unbundled local switching elements that use those elements to originate or terminate intrastate toll calls for end user customers they win from incumbent LECs. States may terminate these mechanisms at any time. We define mechanisms based on intrastate access charges as those mechanisms that require purchasers of intrastate access services from incumbent LECs to pay non-cost-based charges for those access services on the basis of their intrastate access minutes of use.

730. We do not intend, however, that such a transitional mechanism eviscerate the requirements of sections 252 and 254, which, as we have stated, prohibit funding of universal service subsidies through rates for interconnection and unbundled network elements. Mechanisms such as New York's "pay or play" system, which would impose intrastate access charges on non-access services rather than allowing incumbent LECs to recover non-cost-based revenues from purchasers of access services, may not be included in this interim system. Such a result is justified because state "pay or play" mechanisms do not at present constitute a significant revenue stream to incumbent LECs, and therefore elimination of this mechanism is unlikely, in the short term, to have significant detrimental effects on universal service support.

731. These state mechanisms must end on the earlier of: (1) June 30, 1997; or (2) if the incumbent LEC that receives the transitional access charge revenues is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. With one exception, the analysis provided above as to the rationale for the end dates for the transitional interstate access charge mechanism applies here as well. Because our access reform proceeding focuses on federal charges, and because the full extent of the section 254 universal service mechanism remains to be determined in that proceeding, intrastate access charge-based universal service support mechanisms should not now be required to terminate upon the completion of those proceedings.

732. As with our decision to permit incumbent LECs to continue to receive certain interstate access charge revenues from some purchasers of unbundled local switching for a limited period of time, we believe our decision to allow states to preserve certain intrastate universal service support mechanisms based on access charges is within our authority under section 251(d)(1) of the 1996 Act, and section 4(i) of the 1934 Act. Moreover, although section 251(g) does not directly refer to intrastate access charge mechanisms, it would be incongruous to conclude that Congress was concerned about the effects of potential disruption to the interstate access charge system, but had no such concerns about the effects on analogous intrastate mechanisms.

(c) Fifth Amendment Issues

733. We conclude that our decision that prices for incumbent LECs' unbundled elements and interconnection offerings be based on forward-looking economic cost does not violate the incumbent LECs' rights under the Fifth Amendment of the Constitution. The Supreme Court has recognized that

public utilities owned and operated by private investors, even though their assets are employed in the public interest to provide consumers with service, may assert their rights under the Takings Clause of the Fifth Amendment.[1746] In applying the Takings Clause to rate setting for public utilities, the Court has stated that "[t]he guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory."[1747]

734. The Supreme Court has held that the determination of whether a rate is confiscatory depends on whether that rate is just and reasonable, and not on what methodology is used.[1748] In *Federal Power Comm'n v. Hope Natural Gas Co.*, the Court upheld the Federal Power Commission's order that required the company to make a large reduction in wholesale gas rates. The commission based its determination of a reasonable rate of return on a plant valuation determined by using a historical cost methodology that was only half as large as the company's own valuation based on forward-looking reproduction costs. In its decision, the Court set forth the governing legal standard for determining whether a rate is constitutional:

[1746] The Fifth Amendment provides that, "private property [shall not] be taken for public use, without just compensation." U.S. Const. amend. V. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989) *(Duquesne)*.

[1747] *Duquesne*, 488 U.S. at 307 *(citing Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896)).

[1748] *Hope Natural Gas*, 320 U.S. at 602-603; *see also Duquesne; In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); *Jersey Central Power & Light v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987).

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed that is controlling. It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[1749]

735. The Court went on to explain that, in determining whether a rate is reasonable, the regulatory body must balance the interests of both the investor and consumer.[1750] "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business .... [T]he return on the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[1751]

736. Under sections 251(c)(2) and (3) of the 1996 Act, incumbent LECs must establish rates for interconnection and unbundled elements that are just and reasonable.[1752] In adopting the rules that govern those rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope*

[1749] *Hope Natural Gas*, 320 U.S. at 602.

[1750] *Id.*

[1751] *Id.* at 603.

[1752] 47 U.S.C. § 251(c)(2) and (3).

Natural Gas that it is the end result, not the method used to achieve that result, that is the issue to be addressed.[1753] Indeed, the Court has found that the "fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid."[1754] Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred.[1755] Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.

737. Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, including the revenues for other services under our jurisdiction.[1756]

738. In this proceeding, we are establishing pricing rules that should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost

---

[1753] *See, e.g., Duquesne*, 488 U.S. at 310; *Hope Natural Gas*, 320 U.S. at 602.

[1754] *Hope Natural Gas*, 320 U.S. at 601.

[1755] *Duquesne*, 488 U.S. at 301-302.

[1756] However, we may not consider incumbent LECs' revenue derived from services not under our jurisdiction. *Smith v. Ill. Bell*, 282 U.S. 133 (1930).

methodology enables incumbent LECs to recover a fair return on their investment, *i.e.*, just and reasonable rates. The record does not compel a contrary conclusion. No incumbent LEC has provided persuasive evidence that prices based on a forward-looking economic cost methodology would have a significant impact on its "financial integrity." We further note that at least one federal appellate court has held incremental cost-based pricing constitutional.[1757]

739. Incumbent LECs may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates. We also do not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements. As stated above, we intend to explore this issue in detail in our upcoming access reform proceeding.

740. GTE argues that the proper standard to review our ratemaking methodology is the just compensation standard generally reserved for takings of property. This is in effect a contention that the 1996 Act's physical collocation and unbundled network facility requirements constitute physical occupation of their property that should be deemed a taking and that must be subject to "just compensation." Assuming for the sake of argument that the physical collocation and unbundled facilities requirements do result in a taking, we nevertheless find that the ratemaking methodology we have adopted satisfies the just compensation standard. Just compensation is normally measured by the fair market value of the property subject to the

---

[1757] *Metropolitan Transp. Auth. v. Interstate Commerce Commission*, 792 F.2d 287, 297 (2d Cir.), *cert. denied*, 479 U.S. 1017 (1986).

taking.[1758] Just compensation is not, however, intended to permit recovery of monopoly rents.[1759] The just and reasonable rate standard of TELRIC plus a reasonable allocation of the joint and common costs of providing network elements that we are adopting attempts to replicate, with respect to bottleneck monopoly elements, the rates that would be charged in a competitive market,[1760] and, we believe, is entirely consistent with the just compensation standard. Indeed, a similar rate methodology based on incremental costs has been found to satisfy the just compensation requirement.[1761] For these reasons, we conclude that, even if the 1996 Act's physical collocation and unbundled network facility requirements constitute a taking, a forward-looking economic cost methodology satisfies the Constitution's just compensation standard.

[1758] *See, e.g., United States v. Miller*, 317 U.S. 369, 374 (1943) (holding that just compensation can readily be set by ascertaining the property's fair market value, *i.e.*, "what a willing buyer would pay in cash to a willing seller").

[1759] *See, e.g., Lord Mfg. Co. v. United States*, 84 F.Supp. 748, 755-56 (Ct.Cl. 1949), *citing United States v. Cors*, 337 U.S. 325, 334 (1949).

[1760] Compare *Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195, 3200-01 (1988).

[1761] *Metropolitan Transp. Auth. v. Interstate Commerce Commission*, 792 F.2d at 297.

* * *

¶¶ 764 - 765

764. *Geographic Deaveraging*. The 1996 Act mandates that rates for interconnection and unbundled elements be "based on the cost ... of providing the interconnection of network elements."[1802] We agree with most parties that deaveraged rates more closely reflect the actual costs of providing interconnection and unbundled elements. Thus, we conclude that rates for interconnection and unbundled elements must be geographically deaveraged.

765. The record reflects that at least two states have implemented geographically-deaveraged rate zones.[1803] These rate zone pricing systems have generally included a minimum of three zones. In the *Expanded Interconnection* proceeding, the Commission also permitted LECs to implement a three zone structure.[1804] We conclude that three zones are presumptively sufficient to reflect geographic cost differences in setting rates for interconnection and unbundled elements, and that states

---

[1802] 47 U.S.C. § 252(d)(1)(a)(i).

[1803] Connecticut Commission comments at 13; Illinois Commission comments at Attachment C (Illinois Commerce Commission Order), p.54, 60-61.

[1804] *Expanded Interconnection with Local Telephone Company Facilities and Amendment of the Part 69 Allocation of General Support Facility Costs*, CC Docket Nos. 91-141 and 92-222, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7454-57 (1992) (*Expanded Interconnection Order*); Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7426-29 (1993). LEC central offices in areas with the highest traffic densities were assigned to Zone 1; offices in areas with intermediate degrees of density were assigned to Zone 2; and offices in areas with the lowest density were assigned to Zone 3.

may, but need not, use these existing density-related rate zones. Where such systems are not in existence, states shall create a minimum of three cost-related rate zones to implement deaveraged rates for interconnection and unbundled elements. A state may establish more than three zones where cost differences in geographic regions are such that it finds that additional zones are needed to adequately reflect the costs of interconnection and access to unbundled elements.

* * *

¶¶ 790 - 798

790. In general, we believe that states should use a TELRIC methodology to establish geographically deaveraged, flat-rate charges for access to unbundled loops. As discussed above, however, we recognize that, in some cases, it may not be possible for carriers to prepare, or for state commissions to review, economic cost studies within the statutory time frame for arbitration proceedings. Because reviewing and approving such cost studies takes time and because many states have not yet begun, or have only recently begun, to develop and examine such studies, it is critical for the near-term development of local competition to have proxies that provide an approximation of forward-looking economic costs and can be used by states almost immediately. These proxies would be used by a state commission until it is able either to complete a cost study or to evaluate and adopt the results of a study or studies submitted in the record. In an NPRM to be issued shortly, we will investigate more fully various long-run incremental cost models in the record with an eye to developing a model that can be used to generate proxies for the forward looking economic costs of network elements. Until such time as we can develop such a model, we have developed the following default proxy ceilings

that state commissions that have not completed forward looking economic cost studies may use in the interim as an approximation to the forward looking cost of the local loop.

791. State commissions may use this proxy to derive a maximum (or ceiling) loop rate for each incumbent LEC operating within their state, and may establish actual unbundled loop rates at any level less than or equal to this maximum rate in specific arbitrations or other proceedings. Of course, we are encouraging states to have economic studies completed wherever feasible. Moreover, states will have to replace this proxy ceiling with the results of their own forward looking economic cost study or the results produced by a generic economic cost model that the Commission has approved.[1866]

792. We are adopting a proxy ceiling based on two cost models and rates for unbundled loops allowed by six states that had available to them the results of forward-looking economic cost studies at the time they considered either interim or permanent rates for the unbundled loop element. These states are Colorado, Connecticut, Florida, Illinois, Michigan, and Oregon. Each of these states has used a standard that appears to be reasonably close to the forward- looking economic cost methodology that we require to be used, although possibly not consistent in every detail with our TELRIC methodology.[1867]

[1866] *See infra*, Section VII.C.3., discussing generic cost models.

[1867] *See In re: US West Communications, Inc. Filing of Advice Letter No. 2610 In Compliance with Commission Decision No. C96-521 Adopting Emergency Rules (Tariff)*, Docket No. 96S-233T, Decision No. C96-655 (Colorado Commission, June 21,1996)["*Colorado Decision*"] at 59-64 (interim unbundled loop prices set after review of TSLRIC cost studies); *Re Southern New England Telephone Company*, Order No. 95-06-17, *1995 WL 803837 (Conn. D.P.U.C., December 20, 1995)* ["*Connecticut Decision*"] at 9-10, 72 (same); *In re: application of City Signal, Inc., for an* (continued...)

Generally, these states appear to have included an allocation of forward- looking common costs in their unbundled loop prices. The individual state studies resulted in the following average rates for unbundled local loops: Colorado, $18; Connecticut, $12.95; Florida, $17.28; Illinois, $10.93; Michigan, $10.03; and Oregon, $12.45, computed as set forth below.

793. The Colorado Commission set an interim rate of $18 per month for unbundled loops terminated at the main distribution

---

[1867] (...continued)
order establishing and approving interconnection arrangements with Ameritech Michigan, Case No. U-10647 (Michigan Commission, February 23, 1995) ["*Michigan Decision*"] at 32, 56-57 (setting interim unbundled loop rates based on estimated TSLRIC costs); *In Re: Resolution of petition(s) to establish nondiscriminatory rates, terms and conditions for resale involving local exchange companies and alternative local exchange companies and alternative local exchanges companies pursuant to Section 364.161, Florida Statutes*, Docket No. 950984-TP, Order No. PSC-96-0444-FOF-TP, (Florida Commission, March 29, 1996)["*Florida Decision I*"] at 16 (interim unbundled loop prices set with reference to BellSouth cost studies); *In Re: Resolution of petition(s) to establish nondiscriminatory rates, terms and conditions for resale involving local exchange companies and alternative local exchange companies and alternative local exchanges companies pursuant to Section 364.161, Florida Statutes*, Docket No. 950981-TP, Order No. PSC-96- 0811-FOF-TP (Florida Commission, June 24, 1996)["*Florida Decision II*"] at 25- 26 (setting rates after review of GTE and United/Centel cost studies); *In re: Investigation into the Cost of Providing Telecommunications Services*, Order No. 96-188, (Oregon Commission, July19,1996)["*Oregon Decision*"] at 78 n.61 (interim unbundled loop prices generally based on LRIC estimates plus applicable group related costs, and an additional contribution for recovery of joint and common costs); *Illinois Bell Telephone Company Proposed introduction of a trial of Ameritech's Customers First Plan in Illinois*, Docket Nos. 94-0096/94-0117/94-0146/94-0301 (Illinois Commission, April 7, 1995) ["*Customers First Order*"] at 54, 61 (rates set with reference to Ameritech's LRSIC studies).

frame of the LEC switch.[1868] The Connecticut Commission ruled that SNET must provide the following interim unbundled loop prices varying by four zones: metro $10.18; urban $11.33; suburban $15.33; and rural $14.97.[1869] In the absence of further information about customer density or average loop length by zone, we used a simple average equal to $12.95. The Florida Commission set an interim rate for 2-wire loops at $17.00 per month for BellSouth, $15.00 for United/Centel, and $20.00 for GTE.[1870] Using weights equal to the number of loops served by each company in 1994 as reported in the Monitoring Report,[1871] we computed a weighted average price equal to $17.28. Pursuant to its *Customers First* Order, the Illinois Commerce Commission approved tariffs establishing business rates equal to $7.08, $10.92, and $14.45, and residential rates equal to $4.59, $8.67, and $12.14 in three density zones.[1872] Based on data from Table 2.5, page 20 of the Common Carrier Statistics, 1995 Preliminary, we found a 36 percent - 64 percent business residential split. Using Illinois Commission data for number of households in each density zone (996,750 in zone A; 2,788,759 in zone B; 4,594,567 in zone C), we computed an average loop cost of $10.93. The Michigan Commission approved transitional rates of $8.00 per loop for business and $11 per

---

[1868] *Colorado Decision* at 66.

[1869] *Connecticut Decision* at 74.

[1870] *Florida Decision I* at 19; *Florida Decision II* at 25-26.

[1871] Monitoring Report, CC Docket No. 87-339, May 1996 (listing the following number of loops by company: GTE, 1,909,172; United/Centel, 1,627,314; BellSouth, 5,328,280).

[1872] *See* Ameritech Tariff, Ill. C.C. No. 20, Part 19, Section 1, issued October 23, 1995.

loop for residence.[1873] Based on Common Carrier Statistics, 1995 Preliminary data, we computed a 32 percent - 68 percent business-residential split in Michigan, which leads to an average rate of $10.03. The Oregon Commission set the rate for a "basic 2-wire loop set" at $11.95 plus $0.50 for a network access channel connection, for a total price of $12.45.[1874]

794. In order to set a proxy ceiling for unbundled loop elements we make use of the two cost models for which nationwide data are available and upon which parties have had the opportunity to comment in this proceeding. These models are the Benchmark Cost Model (BCM)[1875] and the *Hatfield 2.2*.[1876] Based on our current information, we believe that both these models are based on detailed engineering and demographic assumptions that vary among states, and that the outputs of these models represent sufficiently reasonable predictions of relative cost differences among states to be used as set forth below to set a proxy ceiling on unbundled loop prices for each state. We do not believe, however, that these model outputs by themselves necessarily represent accurate estimates of the absolute magnitude of loop costs. As we

---

[1873] *Michigan Decision* at 94.

[1874] *Oregon Decision* at Appendix C, p.1.

[1875] *Benchmark Cost Model: A Joint Submission by MCI Communications, Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc.* (December 1995), submitted by MCI Communications, Inc., NYNEX Corp., Sprint/United Management Corp., U S West, Inc. on July 24, 1996 (*BCM*). For a more detailed discussion of the *BCM*, *see infra*, Section VII.C.3.

[1876] *Hatfield Model, Version 2.2, Release 1*, (Hatfield Associates, Inc., March 1996), submitted by AT&T and MCI on May 16, 1996 (Hatfield 2.2); *see also* AT&T reply at Appendix D (Update of the Hatfield Model Version 2.2, Release 1). *See infra*, Section VII.C.3., for a more detailed discussion of the various versions of the *Hatfield* model.

discuss below, further analysis is necessary in order to evaluate fully the procedures and input assumptions that the models use in order to derive cost estimates. Furthermore, in the case of *BCM*, model outputs include costs in addition to the cost of the local loop. In order to correct for these considerations, we have developed a hybrid cost proxy in the following manner. First, we have applied a scaling factor to the cost estimates of each model. This scaling is based on the actual rates computed for unbundled loop elements in the six states referred to above. Specifically we have multiplied the cost estimate produced by each model in each state by a factor equal to the unweighted average of rates adopted by state commissions in the six states, divided by the unweighted average of the model cost estimates for the same six states. Our hybrid cost proxy is computed as the simple average of the scaled cost estimates for the two models in each of the 48 contiguous states and the District of Columbia. Neither *BCM* nor *Hatfield 2.2* provide cost estimates for Alaska and only the *BCM* provides an estimate for Hawaii. Our default loop cost proxies for Hawaii and Puerto Rico are based on the default loop cost proxies of the states that most closely approximate them in population density per square mile.[1877] We are not setting default loop cost proxies in this Order for Alaska or for any of the remaining non-contiguous areas subject to the 1996 Act requirement that incumbent LECs offer unbundled loop elements. We are not establishing default loop cost proxies for these areas because we are unsure that comparisons of the population densities of the continental states and of Alaska and other non-contiguous areas subject to the

[1877] There is a strong (negative) correlation between population density and the loop costs reported by all the cost models. The correlation is significant at the 5% level. Population densities are from The Statistical Abstract of the United States 1995, Table Number 23. For Puerto Rico, land area is from Table 361 and population is from Table 1345.

1996 Act fully capture differences in loop costs. Regulatory authorities in those areas may seek assistance from this Commission should default loop cost proxies be needed before they have completed their investigations of the forward-looking costs of providing unbundled loop elements. Since our intention is to establish a ceiling for unbundled loop rates, we believe that it is necessary to take account of the variation in the data that we have used for scaling. While the six states that we considered appear to have based their rates on forward-looking economic cost pricing principles, the actual rates that they approved appear to reflect other factors as well. Furthermore, because only a small number of states have conducted such studies, some upward adjustment is warranted as a safety margin to ensure that the ceiling captures the variation in forward-looking economic costing prices on a state-by-state basis. We have therefore chosen to adjust the hybrid cost estimates upward by five percent for each state. A table listing the proxy ceilings on a statewide average basis is contained in Appendix D.

795. A number of parties have opposed the use of either the *Hatfield* model or *BCM*.[1878] Some critics, for example, have argued that the models may lead to inaccurate cost estimates since these estimates assume that a network is built "from scratch."[1879] Others have criticized specific procedures that have been used in the models to estimate both operating expenses and capital costs. As discussed below in Section VII.C.3., we believe that these criticisms may have merit. In a future rulemaking proceeding, we intend to examine in greater

[1878] For a more detailed discussion of these generic cost models, *see infra*, Section VII.C.3.

[1879] *See, e.g.*, Florida Commission comments at 28-29; USTA comments at 54 n.45; Rural Tel. Coalition reply at 35.

detail various forward looking economic cost models. For the purposes of setting an interim proxy, however, we note that the criticisms have been directed largely toward the absolute level of cost estimates produced by the models, rather than the relative cost estimates across states. Since our hybrid proxy ceiling explicitly scales the model cost estimates based on existing state decisions and uses the model results simply to compute relative prices, we believe that these criticisms do not apply in the present context.

796. We also note that a third model, the *BCM 2*,[1880] could have been used in the construction of our interim cost proxy by simply taking the scaled cost estimates from three cost models instead of two. We have chosen not to follow this approach since parties have not had an opportunity to comment on the possible deficiencies of the *BCM 2*. For comparison purposes, however, we have computed the corresponding ceiling cost estimates, and have found that the scaled costs using the three model proxy are very similar to the estimated costs that were derived using the two models.[1881]

797. As discussed above, we believe that cost-based rates should be implemented on a geographically deaveraged basis. We allow states to determine the number of density zones within the state, provided that they designate at least three zones, but require that in all cases the weighted average of unbundled loop prices, with weights equal to the number of

---

[1880] *Benchmark Cost Model 2* (July 1996), submitted by Sprint Corp. and U S West, Inc., on July 24, 1996 (BCM 2). For a more detailed discussion of this generic cost model, *see infra*, Section VII.C.3.

[1881] The coefficient of correlation is 0.991. Since the models are deterministic,this correlation does not reflect any relevant statistical properties of the models.

loops in each zone, should be less than the proxy ceiling set for the statewide average loop cost set forth in Appendix D.

798. As noted above, we have not yet had sufficient time to evaluate fully any of the cost models that have been submitted in the record, and our hybrid proxy is therefore intended to be used only on an interim basis. We believe that the methodology is consistent with forward-looking cost studies, but we also recognize that there may be situations in which forward looking loop costs will differ from computed costs, and accordingly, we have increased the state average loop costs by five percent and established the proxy as a ceiling. We emphasize that use of the hybrid proxy model can be superseded at any time by a full forward looking economic cost study that follows the guidelines set forth in this order. In addition, we are currently in the process of evaluating the more detailed cost models that have been submitted in the record,[1882] and will issue a further notice on the use of these models in the near future.

* * *

¶ 835

835. These models appear to offer a method of estimating the cost of network elements on a forward-looking basis that is practical to implement and that allows state commissions the ability to examine the assumptions and parameters that go into the cost estimates. Although these models were submitted too late in this proceeding for the Commission and parties to evaluate them fully, our initial examination leads us to believe that the remaining practical and empirical issues can be resolved in the near future. In light of the advantages of such a

---

[1882] For a more detailed discussion of the cost models submitted in this docket, *see infra*, Section VII.C.3.

generic approach, we will further examine these generic economic cost models by the first quarter of 1997 to determine whether we should use one of them to replace the default proxies we adopt in this proceeding. In that event, states would have the option of setting rates in arbitrations on the basis of an economic cost study or by using a generic forward-looking cost model approved at that time.[1988]

* * *

¶¶ 859 - 862

859. We conclude that the term "nondiscriminatory" in the 1996 Act is not synonymous with "unjust and unreasonable discrimination" in section 202(a), but rather is a more stringent standard.[2057] Finding otherwise would fail to give meaning to Congress's decision to use different language. We agree, however, with those parties that argue that cost-based differences in rates are permissible under sections 251 and 252.

860. Section 252(d)(1), for example, requires carriers to base interconnection and network element charges on costs. Where costs differ, rate differences that accurately reflect those differences are not discriminatory. This is consistent with the economic definition of price discrimination, which is "the practice of selling the same product at two or more prices where

---

[1988] We note that we address certain criticisms of the models in the context of their use in the development of the proxy for the unbundled local loop, *supra*, Section VII.C.2.b.(1)(b).

[2057] *See supra*, Section IV.G, discussing nondiscriminatory terms and conditions for interconnection, and *supra*, Section V.G., discussing nondiscriminatory terms and conditions for unbundled network elements.

the price differences do not reflect cost differences ... An important feature of the economic definition of price discrimination is that it occurs not only when prices are different in the presence of similar costs but also *when the prices are the same and the costs of supplying customers are different.*"[2058] As one economist has recognized, differential pricing is "one of the most prevalent forms of marketing practices" of competitive enterprises.[2059] Strict application of the term "nondiscriminatory" as urged by those commenters who argue that prices must be uniform would itself be discriminatory according to the economic definition of price discrimination. If the 1996 Act is read to allow no price distinctions between companies that impose very different interconnection costs on LECs, competition for all competitors, including small companies, could be impaired. Thus, we find that price differences, such as volume and term discounts, when based upon legitimate variations in costs are permissible under the 1996 Act, if justified.

861. On the other hand, price differences based not on cost differences but on such considerations as competitive relationships, the technology used by the requesting carrier, the nature of the service the requesting carrier provides, or other factors not reflecting costs, the requirements of the Act, or applicable rules, would be discriminatory and not permissible under the new standard. Such examples include the imposition of different rates, terms and conditions based on the fact that the competing provider does or does not compete with the

---

[2058] David L. Kaserman & John W. Mayo, Government & Business: *The Economics of Antitrust & Regulation* at 273-74 (1995) (*citing* George J. Stigler, *The Theory of Price* (3d ed. 1966)) (emphasis added).

[2059] Hal R. Varian, "Price Discrimination," in *Handbook of Industrial Organization*, vol.1, p. 598 (R. Schmalensee and R.D. Willig eds., 1989).

incumbent LEC, or offers service via wireless rather than wireline facilities. We find that it would be unlawfully discriminatory, in violation of sections 251 and 252, if an incumbent LEC were to charge one class of interconnecting carriers, such as CMRS providers, higher rates for interconnection than it charges other carriers, unless the different rates could be justified by differences in the costs incurred by the incumbent LEC.

862. State regulations permitting non-cost based discriminatory treatment are prohibited by the 1996 Act. This conclusion is consistent with both the letter and the spirit of the 1996 Act and our determination that the pricing for interconnection, unbundled elements, and transport and termination of traffic should not vary based on the identity or classification of the interconnector.[2060]

* * *

¶ 875

875. We conclude that section 251(c)(4) does not require incumbent LECs to make services available for resale at wholesale rates to parties who are not "telecommunications carriers" or who are purchasing service for their own use. The wholesale pricing requirement is intended to facilitate competition on a resale basis. Further, the negotiation process established by Congress for the implementation of section 251 requires incumbent LECs to negotiate agreements, including resale agreements, with "requesting telecommunications carrier

---

[2060] *See infra*, Section XI.A., discussing transport and termination rates.

or carriers,"[2096] not with end users or other entities. We further discuss the definition of "telecommunications carrier" in Section IX. of the Order.

* * *

¶¶ 907 - 908

907. Resale will be an important entry strategy for many new entrants, especially in the short term when they are building their own facilities. Further, in some areas and for some new entrants, we expect that the resale option will remain an important entry strategy over the longer term. Resale will also be an important entry strategy for small businesses that may lack capital to compete in the local exchange market by purchasing unbundled elements or by building their own networks. In light of the strategic importance of resale to the development of competition, we conclude that it is especially important to promulgate national rules for use by state commissions in setting wholesale rates. For the same reasons discussed in Section II.D of the Order, we believe that we have legal authority under the 1996 Act to articulate principles that will apply to the arbitration or review of wholesale rates. We also believe that articulating such principles will promote expeditious and efficient entry into the local exchange market. Clear resale rules will create incentives for parties to reach agreement on resale arrangements in voluntary negotiations. Clear rules will also aid states in conducting arbitrations that will be administratively workable and will produce results that satisfy the intent of the 1996 Act. The rules we adopt and the determinations we make in this area are crafted to achieve these

---

[2096] 47 U.S.C. § 252(a)(1).

purposes. We also note that clear resale rules should minimize regulatory burdens and uncertainty for all parties, including small entities and small incumbent LECs.[2192]

908. The statutory pricing standard for wholesale rates requires state commissions to (1) identify what marketing, billing, collection, and other costs will be avoided by incumbent LECs when they provide services at wholesale; and (2) calculate the portion of the retail prices for those services that is attributable to the avoided costs. Our rules provide two methods for making these determinations. The first, and preferred, method requires state commissions to identify and calculate avoided costs based on avoided cost studies. The second method allows states to select, on an interim basis, a discount rate from within a default range of discount rates adopted by this Commission. They may then calculate the portion of a retail price that is attributable to avoided costs by multiplying the retail price by the discount rate.

* * *

¶ 915

915. The 1996 Act requires that wholesale rates be based on existing retail rates, and thus clearly precludes use of a "bottom up" TSLRIC study to establish wholesale rates that are not related to the rates for the underlying retail services. We thus reject the suggestions of those parties that ask us to require use of TSLRIC to set wholesale rates. The 1996 Act does not, however, preclude use of TSLRIC cost studies to identify the portion of a retail rate that is attributable to avoided retail costs. TSLRIC studies would be entirely appropriate in states where

---

[2192] *See* Regulatory Flexibility Act, 5 U.S.C. §§601 *et seq*.

the retail rates were established using a TSLRIC method. For example, the Illinois Commission calculated its wholesale rate using an avoided cost formula and long run incremental cost studies. Embedded cost studies, such as the studies used by the Georgia Commission, may also be used to identify avoided costs. Ideally, a state would use a study methodology that is consistent with the manner in which it sets retail rates.

* * *

¶ 965

965. In the NPRM, we sought comment on whether an incumbent LEC can avoid making a service available at wholesale rates by ceasing to offer the retail service on a retail basis, or whether the incumbent should first be required to make a showing that withdrawing the offering is in the public interest or that competitors will continue to have an alternative way of providing service. We also asked if access to unbundled elements addresses the concern that incumbent LECs could withdraw retail services.[2273]

* * *

¶ 1054

1054. We conclude that the pricing standards established by section 252(d)(1) for interconnection and unbundled elements, and by section 252(d)(2) for transport and termination of traffic, are sufficiently similar to permit the use of the same general methodologies for establishing rates under both statutory provisions. Section 252(d)(2) states that reciprocal

---

[2273] NPRM at para. 175.

compensation rates for transport and termination shall be based on "a reasonable approximation of the additional costs of terminating such calls."[2526] Moreover, there is some substitutability between the new entrant's use of unbundled network elements for transporting traffic and its use of transport under section 252(d)(2). Depending on the interconnection arrangements, carriers may transport traffic to the competing carriers' end offices or hand traffic off to competing carriers at meet points for termination on the competing carriers' networks. Transport of traffic for termination on a competing carrier's network is, therefore, largely indistinguishable from transport for termination of calls on a carrier's own network. Thus, we conclude that transport of traffic should be priced based on the same cost- based standard, whether it is transport using unbundled elements or transport of traffic that originated on a competing carrier's network. We, therefore, find that the "additional cost" standard permits the use of the forward-looking, economic cost-based pricing standard that we are establishing for interconnection and unbundled elements.[2527]

* * *

¶ 1056

1056. Consistent with our conclusions about the pricing of interconnection and unbundled network elements, we conclude that states that elect to set rates through a cost study must use the forward-looking economic cost-based methodology, which is described in greater detail above, in establishing rates for reciprocal transport and termination when arbitrating

---

[2526] 47 U.S.C. § 252(d)(2)(A)(ii).

[2527] *See supra*, Section VII.B.

interconnection arrangements.[2529] We find that section 252(d)(2)(B)(ii), which indicates that section 252(d)(2) shall not be construed to "authorize the Commission or any State to engage in any rate regulation proceeding to establish with particularity the additional costs of transporting or terminating calls,"[2530] does not preclude states or this Commission from reviewing forward- looking economic cost studies. First, we believe that Congress intended the term "rate regulation proceeding" in section 252(d)(2)(B)(ii) to mean the same thing as "a rate-of-return or other rate-based proceeding" in section 252(d)(1)(A)(i). In the section on the pricing of interconnection and unbundled elements above, we conclude that the statutory prohibition of the use of such proceedings is intended to foreclose the use of traditional rate case proceedings using rate-of-return regulation. Moreover, forward-looking economic cost studies typically involve "a reasonable approximation of the additional cost,"[2531] rather than determining such costs "with particularity," such as by measuring labor costs with detailed time and motion studies.

* * *

¶ 1065

1065. We are concerned that some new entrants that do not already have interconnection arrangements with incumbent LECs may face delays in initiating service solely because of the

---

[2529] *See supra*, Section VII.B. for a complete discussion of forward-looking economic cost-based methodology.

[2530] 47 U.S.C. § 252(d)(2)(B)(ii).

[2531] 47 U.S.C. § 252(d)(2)(A)(ii).

need to negotiate transport and termination arrangements with the incumbent LEC. In particular, a new entrant that has already constructed facilities may have a relatively weak bargaining position because it may be forced to choose either to accept transport and termination rates not in accord with these rules or to delay its commencement of service until the conclusion of the arbitration and state approval process. To promote the Act's goal of rapid competition in the local exchange, we order incumbent LECs upon request from new entrants to provide transport and termination of traffic, on an interim basis, pending resolution of negotiation and arbitration regarding transport and termination prices, and approval by the state commission. A carrier may take advantage of this interim arrangement only after it has requested negotiation with the incumbent LEC. The interim arrangement shall cease to be in effect when one of the following occurs: (1) an agreement has been negotiated and approved; (2) an agreement has been arbitrated and approved; or (3) the period for requesting arbitration has passed with no such request. We also conclude that interim prices for transport and termination shall be symmetrical. Because the purpose of this interim termination requirement is to permit parties without existing interconnection agreements to enter the market expeditiously, this requirement shall not apply with respect to requesting carriers that have existing interconnection arrangements that provide for termination of local traffic by the incumbent LEC. The ability to interconnect with an incumbent LEC prior to the completion of a forward-looking, economic cost study, based on an interim presumptive price ceiling, allows carriers, including small entrants, to enter into local exchange service expeditiously.[2544]

[2544] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq*.

* * *

Separate Statement of Commissioner Rachelle B. Chong

The passage of the Telecommunications Act of 1996[3276] marked the end of more than sixty years of monopoly style regulation. The changes wrought by the 1996 Act on the telephone industry are dramatic and comprehensive. I write separately to emphasize my strong belief that the pro-competitive path we have unanimously chosen in this interconnection order is the right one.

On the day the 1996 Act became law, the Commission embarked on a challenging journey to help implement the new statute. Our final destination has been clearly delineated by Congress. We are "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition."[3277]

True to this charge, we have resolved to act quickly and decisively to open all telecommunications markets to competition, to provide pricing methodologies that will drive rates toward cost, and to provide a national policy framework that will achieve this restructuring of the industry in an orderly and efficient manner. The rules in this item do not favor any particular industry or player over another, but instead free them from outdated regulatory restraints in order to compete with each other.

[3276] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 *to be codified at* 47 U.S.C. § 151 *et. seq*. (1996 Act).

[3277] S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996).

The 1996 Act opens up the local telephone network to competitors, and provides them with unprecedented access through an interconnection framework.[3278] The Act provides three methods of entry through which a competitor may enter the local telephone market: (1) full facilities-based entry; (2) purchase of unbundled elements from the incumbent local exchange carrier (LEC), i.e. network "piece parts;" and (3) resale, which gives a competitor the ability to purchase an incumbent LEC's retail service at a wholesale price and repackage it for sale to the competitor's own end user.

Facilities-based Competition. The first entry option -- facilities-based competition -represents the most dramatic departure from our current bottleneck monopoly structure. A full facilities-based competitor would offer a myriad of distinct services through separate facilities to its subscribers, and thus providing consumers with the benefits of head-to-head competition. As a practical matter, however, we do not expect a market typified by full-fledged facilities-based competition to blossom overnight. These networks or systems must be planned, financed and constructed over time. As a result, the other two entry avenues -- the purchase of unbundled elements and resale -- take on a special importance in the near term to bring swift competition to the local marketplace.

Unbundled Elements. Some new entrants already have some network infrastructure in place, and lack only a few critical components in order to provide local exchange service to consumers. For example, today's cable operators have a coaxial wire that passes over 96.6% of the TV households in

[3278] Interconnection refers to the physical linking of two networks for the mutual exchange of traffic.

America.[3279] If a cable operator can access the remaining necessary network elements from the incumbent LEC, the cable operator would be only a step away from providing local telephone service over its upgraded network. This example points out why it is essential for new entrants to obtain access to those network piece parts. In our order, we set forth a minimum list of unbundled network elements that incumbent LECs uniformly must make available to new entrants upon request. The state commissions may expand upon this list. We believe that this action will give new entrants what they need so competition is "jump started."

Resale. Resale is another critically important entry strategy because three types of new entrants stand to benefit. First, facilities-based competitors that want to immediately enter the market prior to completing their own networks can use resale as a transition mechanism. Second, facilities- based competitors whose existing infrastructure does not overlap the incumbent LEC's service area, may choose to use resale to ensure that it can offer a competing local service package within the same service territory as the incumbent LEC. Third, new entrants who do not intend to offer facilities-based competition will be able to compete immediately in the local market by purchasing discounted services of the incumbent LEC. For all of these categories, our decision provides a viable avenue for immediate market entry.

Free Market Negotiations. I highlight that the 1996 Act has made the mechanism for entry a *free* market negotiation process between the incumbent LEC and any potential new competitor. Under Section 252(a)(1), the Commission's Section 251 rules play no role if an incumbent LEC and a new entrant reach a purely voluntary agreement, and the state

[3279] Paul Kagan Associates, Inc., *Marketing New Media*, Mar. 18, 1996.

commission approves it through the process set forth in Section 252.

Need for Minimum National Baselines. It is only if the carriers are unsuccessful in their voluntary negotiations that government steps in. The Act provides that the state commissions arbitrate the disputes. In today's order, we set forth a baseline of terms and conditions for an arbitrated interconnection agreement. I support this action for three reasons. First, because interconnection matters are very complex and technical, I believe that minimum national guidelines will help parties lower their transaction costs and will help drive them to reach their voluntary agreements much faster. At the outset of their voluntary negotiations, parties will understand what their minimum rights will be in a subsequent state commission arbitration process; it is our hope this may encourage earlier agreement.

Second, a baseline of terms and conditions simplifies the state commission arbitration process. A baseline enables a state commission to quickly approve an agreement and thus rapidly introduce competition. The presence of a baseline minimizes any regulatory delay that might result if a state commission were to establish from scratch its own pricing methodology or conduct a proceeding to identify network elements that must be unbundled.

Third, in establishing some national minimum baselines, we greatly aid new entrants who have national or regional strategies. Without such baselines, these competitors would face a "patchwork quilt" of differing state regulatory requirements that may create a potential entry barrier by increasing their entry costs and causing substantial delay. Thus, it is my view that these baselines promote swift competitive entry, which in turn will lead to the earlier introduction of competitive services to consumers.

Access Charge Transition. Although we take a great leap forward toward competition with this interconnection order, our goal in making local telephone competition a reality will not be complete until we finish universal service reform and restructure our current access charge regime. Our order notes that the Act sets forth a specific time frame by which the Commission must issue final rules as to interconnection (August 1996) and universal service reform (May 1997). Because of the time differential between these dates, and in order to avoid undue disruption of the incumbent LECs' ability to support universal service, I have supported our decision to require new entrants when purchasing unbundled elements to pay a portion of certain access charges until no later than June 30, 1997. My support for the establishment of a short term access charge transition scheme is premised on the Commission's firm commitment to complete universal service and access charge reform by the first half of 1997. I underscore my determination that the interim access charge mechanism proposed herein is of a finite duration. I can foresee no circumstance upon which it would be extended beyond the dates set forth in our order.

Pricing Methodology. Prices of interconnection and unbundled elements, along with prices for transport and termination and resale, are all crucial to any interconnection agreement. Again, should the parties voluntarily agree on such prices, these agreements will be submitted to the states for approval and there is no government intervention in the process.

If carriers cannot agree, however, today's decision makes clear that the FCC will *not* set these prices. The Act provides that the appropriate state commission will step in to set prices. To help guide state commissions as they set prices according to local conditions, we have established methodological pricing principles that are consistent with the Act's cost-based pricing provisions. We have asked the state

commissions to use the cost-based pricing methodology described in our order when they conduct an economic cost study to set their state specific rates. A clear benefit of this approach is that such a national framework will encourage the swift establishment of a common, pro- competition understanding of pricing principles among the states.

We also have established certain default proxies that states will use in the interim, if they have not completed a cost study during an arbitration, or if they lack the necessary resources to initiate their own cost study. It is my view that these default proxies, which are either price ceilings or price ranges, will greatly speed competition. For example, in a situation where the state commission has not yet completed a cost study but must render a decision on specific pricing issues in an arbitration pursuant to the deadline imposed by Section 252(e)(4), the default proxies will assist the state commission in resolving the pricing issues quickly and in a way consistent with the Act's cost-based pricing principles.

I emphasize that a state commission has the flexibility to set a specific rate that is either above or below the default proxy ceiling or range if it has conducted its own cost study consistent with the pricing methodology set forth in our order. The default proxy is only an interim mechanism and it may not be relied upon once a state commission has completed its own economic cost study.[3280]

CMRS-LEC Interconnection Issues. In our order, I have supported our decision to allow CMRS-LEC interconnection matters to be governed by the Sections 251/252 provisions,

---

[3280] It is unfortunate that we did not have enough of a record in this proceeding to decide what would be an appropriate proxy for paging carriers' termination costs or to set a default proxy. I am committed to moving forward with a further rulemaking proceeding on this issue as quickly as possible.

while continuing to acknowledge our continuing jurisdiction pursuant to Section 332 over CMRS-LEC interconnection matters. In doing so, we have declined to opine on the precise extent of our Section 332 jurisdiction over CMRS-LEC interconnection matters, however. I emphasize that by opting to use the Section 251/252 framework, we are not repealing our Section 332 jurisdiction by implication or rejecting Section 332 as an alternative basis for jurisdiction.

While we have generally crafted our interconnection rules not to favor any particular industry, player or technology over another, we cannot shut our eyes to inherent differences between some classes of carriers' services that may pose potential problems when we seek to apply our new interconnection rules. I believe that should the need arise in the future, we should not hesitate to adapt some of our general interconnection rules to recognize the unique nature of particular classes of service providers, such as CMRS providers. It is for this reason that I supported the Commission's decision to reserve its right to exercise jurisdiction over LEC-CMRS interconnection under Section 332.

There are several differences that set wireless CMRS providers apart from some of the other telecommunications carriers that will avail themselves of the Sections 251 and 252 interconnection framework. First, when adopting Section 332 in 1993, Congress created a national regulatory framework for CMRS providers, and granted the FCC authority to preempt states from entry and rate regulation.
Congress made clear that its intent was to "foster the growth and development of mobile services that, by their nature, operate without regard to state lines as an integral part of the

national telecommunications infrastructure."[3281] This recognition that CMRS services are uniquely interstate in scope was apt. CMRS service areas, which are established federally, can encompass more than one state jurisdiction.[3282] Congress was rightly concerned that imposing multiple state regulatory schemes on CMRS providers may prove unduly burdensome, cause delay, and otherwise inhibit the industry's growth. Notably, Congress did not repeal Section 332 when it provided new Sections 251 and 252 in the 1996 Act.

Second, CMRS providers have suffered past discrimination at the hand of the LECs and by certain state commissions with regard to interconnection matters. Today's record is replete with examples of LECs that have significantly overcharged CMRS providers for past interconnection. Further, in violation of our rules, our record reflects that in some cases, LECs have refused to pay CMRS providers for calls terminated by LECs on the CMRS networks, while other wireline carriers have received such compensation from the LECs. In other instances, LECs have required certain CMRS providers to pay for the traffic the LEC carrier originates and terminates on the

---

[3281] H.R. Report No. 103-11, 103rd Cong., 1st Sess. 260 (1993).

[3282] For example, Personal Communications Service (PCS) providers in the Washington -Baltimore Major Trading Area (MTA) are subject to six jurisdictions -- Pennsylvania, Delaware, Maryland, Virginia, West Virginia and the District of Columbia -- due to the large size and location of the federally set service areas. Should one of these PCS providers need to arbitrate an interconnection agreement pursuant to Section 251 and 252, such PCS provider could be subjected to as many as six state arbitration proceedings. This scenario could impose undue burdens, such as increased transaction costs, regulatory delay, and the potential for inconsistent results, for CMRS providers with interstate service areas. For this reason, we reserve our right to in the future to use Section 332 as an alternative basis for jurisdiction over CMRS providers faced with this type of a dilemma.

systems of the CMRS provider. These problems have been compounded by certain state commissions who have limited access by CMRS providers to more reasonable interconnection rates afforded by LECs to other wireline carriers.

In this order, we have taken a variety of measures to remedy this discrimination and to ensure that CMRS providers are placed on an even footing with other telecommunications carriers when obtaining LEC interconnection. I am particularly pleased that we will allow CMRS providers with current interconnection agreements that provide for non-mutual compensation an opportunity to renegotiate those agreements under the framework of Sections 251/252, without incurring any early termination penalties. In light of the past discrimination CMRS providers have experienced, however, I would have taken two additional steps.

First, I would have extended the "fresh look" opportunity to all CMRS providers -- not just those with non-mutual compensation arrangements. Our decision was to limit relief in this instance to contracts that are clearly unlawful because they violate Section 20.11 of our rules. Section 20.11, however, requires not only that CMRS-LEC interconnection agreements comply with principles of mutual compensation, but also that each carrier pay reasonable compensation. I believe that the record in this proceeding clearly demonstrates that the rates the LECs have charged CMRS providers have far exceeded their costs and thus could not fairly be characterized as "reasonable" compensation.

Second, instead of requiring the CMRS providers to continue paying their current interconnection rates, I would have permitted CMRS providers to immediately begin paying the default proxy rate while their interconnection arrangements were being renegotiated.

It is my hope that on a going-forward basis, CMRS providers will be able to obtain fair, reasonable and non-

discriminatory interconnection rates under the terms of today's decision. For reasons of simplicity and regulatory parity, it makes sense to me to have a single regulatory scheme pursuant to Sections 251 and 252 apply as to all incumbent LEC interconnection matters. Bearing in mind Congress' concerns about the interstate nature of the CMRS industry, however, I have concerns that the state-by-state arbitration process may pose undue burdens on, or otherwise hinder the growth of, the CMRS industry. If it does, I would not hesitate to invoke our Section 332 jurisdiction if I believe that the framework we impose today is having adverse impacts on the CMRS industry.

IN THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

GTE Service Corporation, et al.	)	Case No. _____
v.	)	(DC Circuit Case No. 96-1319)
Federal Communications Commission, et al.	)	(Cons. with Case No. 96-3321)

SUPPLEMENTAL AFFIDAVIT OF DENNIS B. TRIMBLE

STATE OF TEXAS §
§
COUNTY OF DALLAS §

Dennis B. Trimble, being duly sworn according to law, states as follows:

1. My name is Dennis B. Trimble and I am the Assistant Vice President - Marketing Service (Acting) for GTE Telephone Operations ("GTE" or "the Company"). In that capacity I [*2*] am responsible for, among other matters, analyzing the demand characteristics of GTE's regulated product offerings and developing costs, prices and associated tariff filings for all of GTE's regulated services, inclusive of tariff filing activity with the FCC.

2. I have over 20 years experience with GTE. During this time I have held various positions throughout the Company, almost all related to demand analysis, market research, forecasting, and/or the pricing of regulated telecommunication services. I have a B.A. in Business (1970) and an M.B.A.

(1973) both from Washington State University. In 1972, I became an Assistant Professor at the University of Idaho, where I taught courses in statistics, operations research and decision theory. From 1973 through 1976, I completed course work toward a Ph.D. degree in Business at the University of Washington, majoring in quantitative methods with minors in computer science, research methods, and economics.

3. I have reviewed in detail the Federal Communications Commission's ("FCC") *First Report and Order* in CC Docket No. 96-98 which was issued on August 8, 1996. Among other things, the *First Report and Order* establishes (at ¶¶789-827) default proxy ceiling prices that are to be used after an arbitration proceeding as the price for unbundled network elements unless a state regulatory agency has completed its review of studies that comport to the FCC's prescribed, new costing methodology.

4. I previously provided an affidavit (*Original Trimble Affidavit*) that was attached to the Joint Motion of GTE Corporation and the Southern New England Telephone Company for Stay Pending Judicial Review filed with the FCC ("*GTE/SNET FCC Motion*"). The *Original Trimble Affidavit* had two main purposes: (i) to describe the GTE cost studies submitted in a [*3*] Florida Public Service Commission ("FPSC") proceeding that were used by the FCC in developing a proxy for the outcome of a study conducted according to its new cost methodology; and (ii) to compare the forward-looking cost studies typically prepared by GTE with the new, forward-looking costing methodology required by the *First Report and Order*. To recap that discussion, GTE's forward-looking cost studies use a Total Service Long Run Incremental Cost ("TSLRIC") methodology. The *First Report and Order* requires use (at ¶¶ 672-703) of a methodology the FCC calls

Total Element Long Run Incremental Cost ("TELRIC"). The primary difference lies in the allocation of common costs that cannot be directly assigned to a particular service or network element. GTE's methodology would assign all common costs to various services during the pricing process, using a method based on the market-allowed contribution levels. The FCC's methodology assigns as much of the common costs as possible to each network element if there is any possible reasonable relationship that can be used for assignment. For the remaining costs for which a reasonable relationship simply does not exist (*e.g.*, the company president's salary), the *First Report and Order* describes (at ¶¶ 694-699) a pricing development procedure using "reasonable" allocation methodologies (*e.g.*, uniform percent markup).

5. The *Original Trimble Affidavit* demonstrated that the FCC's reliance upon the GTE Florida study output as a reasonable approximation of the cost estimates that would be produced by a study conducted using the new FCC methodology was flawed. It further showed that the result of a cost study based on the FCC methodology will be higher than that of the GTE [*4*] study because a greater amount of common costs are assigned in the costing process, rather than in the pricing process. Yet inexplicably, the FCC's proxy price ceilings are set substantially lower than either the purely incremental costs produced by GTE's methodology (that do not include common costs), or those incremental costs adopted by the FPSC that allowed a very small allocation of common costs.

6. The three purposes of this supplemental affidavit are: (i) to discuss the serious flaws in the FCC's loop proxy price development process; (ii) to compare the results of cost studies prepared using the FCC's prescribed methodology that GTE has completed during the period following the filing of the

GTE/SNET FCC Motion with the FCC's mandatory proxy price ceilings; and (iii) to compare the revenues that would be obtained using the FCC's proxy prices from an average residence or business service in GTE's California service area both the revenues generated from elements priced at TELRIC and to current average per line revenues. As the attached Exhibits 1 and 2 demonstrate, when GTE adheres to the FCC's prescribed costing methodology, the costs that result are much higher than the mandatory proxy ceiling prices. Specifically, GTE's loop costs average at least 50 percent larger than the FCC's ceiling price. As described following, this result is not startling because the FCC based its statewide average loop proxy price calculations on inputs that do not represent actual statewide average loop costs. GTE's unbundled end office switching costs average at least two-and-a-half times the FCC's price ceiling of $0.004 per minute, even when all possible switching features and functions are not included. Moreover, as Exhibit 3 shows, when GTE compares the revenues that would be [*5*] obtained from the FCC's proxy prices to either the revenues from elements priced at the TELRICs computed by GTE or to current revenues per line, it is clear that a large gap exists. It is also obvious that the effective discount from the equivalent retail service price using the FCC proxy prices is much larger than the discount ceiling established by the FCC for resold services.

7. The *First Report and Order* specified (at ¶ 744) that the rate for unbundled local loops be a flat, per-month charge. Further, the FCC specified (at ¶ 794, Appendix D) the statewide average ceiling price that a state regulatory agency could adopt in an arbitration proceeding unless the state commission had completed its review of cost studies that comport to the FCC methodology.

8. The FCC's derivation of loop proxy prices is seriously flawed and cannot in any way be portrayed as representative of GTE's loop costs. The FCC used three sets of 6 numbers (or 18 numbers in total) to calculate the loop proxy price. First, the FCC used the loop prices adopted by 6 state commissions (Colorado, Connecticut, Florida, Illinois, Michigan, Oregon). GTE does not operate in two of those states, and the state agency decisions in three of the four other states involved only the regional Bell Operating Company ("BOC"). The FCC's use of prices developed for BOC serving areas is surprising on its face, because the *First Report and Order* (at n.1877) recognized that there "is a strong (negative) correlation between population density and the loop costs." (This simply means that the higher the population density, the lower the cost, and the lower the population density, the higher the cost.) Because BOC serving areas are far more densely populated that GTE's serving areas, this alone seriously understates the [*6*] proxy price that would be representative for GTE. Moreover, the involved state commissions did not rely upon cost study methodologies that were anywhere close to the FCC's prescribed methodology.

9. Second, the FCC used the results of two cost models, the Benchmark Cost Model (BCM) and the Hatfield 2.2 model for the same 6 states. This is also surprising because the *First Report and Order* admits (at ¶ 835) that both of these models "were submitted too late in this proceeding for the Commission and parties to evaluate them fully." And, GTE's preliminary evaluations of each model reveals that both systematically produce absurdly low cost estimates. The BCM model does not contain the service drop (the wire from the end of the cable to the customer premises) or other vital loop cost components (*e.g.*, cross-connects, splice pedestal terminals, splicing). GTE has already described the numerous shortcomings of the

Hatfield 2.2 model, including the fact that it understates loop costs by at least $8 per loop. (*See First Report and Order* at ¶ 831)

10. Third, the FCC used these 18 numbers in an extremely simplistic calculation methodology. It calculated a proxy price by averaging the results of two calculations for each state and increasing that average by 5 percent. The two calculations were the result of multiplying the BCM and Hatfield 2.2 cost estimates by a so-called "scaling factor." The "scaling factor" was derived by dividing the simple average of the 6 state commission prices by the sum of the average of the BCM and the Hatfield 2.2 estimates for the same 6 states. [*7*]

Mathematically, this is expressed as:

$$\text{Proxy Price}_{\text{state i}} = ((\text{Proxy Price}_{\text{BCM for state i}} + \text{Proxy Price}_{\text{Hatfield 2.2 for state i}}) \text{ divided by 2) times 1.05, where}$$

$$\text{Proxy Price}_{\text{BCM for state i}} = (\text{BCM estimate for state i) times ((average of 6 state prices) divided by (average of 6 state BCM estimates)), and}$$

$$\text{Proxy Price}_{\text{Hatfield 2.2 for state i}} = (\text{Hatfield 2.2 estimate for state i) times ((average of 6 state prices) divided by (average of 6 state Hatfield 2.2 estimates)).}$$

11. Because the state commission prices were not representative of statewide averages, and were in fact based predominately on BOC data, the FCC clearly erred in relying upon those prices to compute statewide average proxy prices. Further, because both the BCM and Hatfield 2.2 models are fundamentally flawed and have not been rigorously review by

the FCC or by the parties subjected to the results of calculations based upon those models, the FCC clearly erred in relying upon those cost estimates.

12. GTE's TELRIC cost studies are based upon the methodology prescribed by the *First Report and Order* (at ¶¶ 672-702). GTE first calculated the direct forward-looking cost of each network element. GTE then determined the common costs that could not be attributed to any particular element or sub-group of elements. According to the FCC's methodology, these latter costs are to be allocated to all network elements during the pricing process.

13. Exhibit 1 shows the results of the GTE cost studies for loops in several states where GTE serves a large number of customers. The cost developed using a TELRIC [*8*] methodology averages 50 percent larger than the FCC's proxy ceiling price. This difference clearly supports my conclusion in the *Original Trimble Affidavit* (at ¶ 9-14) that the FCC's loop proxy price is arbitrary and inappropriate because it is based upon a mixture of cost estimates for only the bare incremental cost of a loop, rather than being based upon a TELRIC methodology. Further, to assure a proper comparison, neither the proxy price nor the GTE TELRIC results described above include any allocation of common costs as the FCC's own cost methodology requires. Exhibit 2 also shows a comparison of the FCC proxy prices with the output of a new version of the BCM, called BCM II. The BCM II was developed in response to various criticisms of the BCM. Thus, BCM II should be more reflective of forward-looking loop costs than BCM. In the ten GTE serving areas, the BCM II estimates are more than double the proxy prices. This result also supports my conclusion that the FCC's loop proxy prices are woefully low.

14. The *First Report and Order* specified (at ¶ 412) that the unbundled local switching network element is to include not only line-to-line and line-to-trunk "basic switching," but also all of the features, functions, and capabilities, such as a telephone number, directory listing, dial tone, signaling, and access to 911, operator services and directory assistance, all vertical features including custom calling and CLASS features, Centrex, and any technically feasible customized routing functions. The unbundled local switching rate structure is required to include "a combination of a flat-rated charge for line ports, which are dedicated to a single new entrant, and either a flat-rate or per-minute usage charge for the switching matrix and for trunk ports, which constitute shared facilities, best reflects the way costs for unbundled local [*9*] switching are incurred." *Id.* at ¶ 810. Unless a state regulatory agency has completed its review of cost studies that comport with the FCC's costing methodology, state agencies are required (*Id.* at ¶ 815) to set the rate for unbundled local switching "so that the sum of the flat-rated charge for line ports and the product of the projected minutes of use per port and the usage-sensitive charges for switching and trunk ports, all divided by the projected minutes of use, does not exceed 0.4 cents ($0.004) per minute of use and is not lower than 0.2 cents ($0.002) per minute of use."

15. Exhibit 2 compares the FCC's proxy price for unbundled local switching to the results of cost studies prepared by GTE using the FCC's TELRIC methodology. Shown are GTE's cost estimates for three end office switching cost elements for a number of states where GTE serves a large number of customers. Those elements are: (i) a per minute cost to switch a call; (ii) a per line per month cost for the non-usage sensitive components of a switch (*e.g.*, line card); and (iii) a per line per month cost for a representative feature package. The cost element of a per line, per month cost for the feature

package was chosen to comply with the FCC's mandate that a rate structure recover costs "in a manner that efficiently apportions costs among users." *First Report and Order* at ¶ 755. It is very important to note that the feature package selected for illustrative purposes does not include all of the features, functions and capabilities that a switch may be capable of providing. The package selected includes only many of the most commonly used features (*e.g.*, Call Waiting, Emergency Bureau Access, Speed Calling, Time of Day Routing). Also not included in any of the three cost estimates in Exhibit 2 are the costs associated with a directory listing or the more esoteric switch features such as customized routing [*10*] and Meet-Me Conference Bridging. The feature package used in calculating the cost for two states shown in Exhibit 2, Ohio and Wisconsin, did include additional, more advanced features, just to show the potential cost impact on a per minute basis.

16. To provide a logical comparison, GTE converted the two per line, per month cost elements into an equivalent per minute cost by dividing by the average switched minutes of use per month, including minutes associated with both local and long distance calls. The result of this calculation is a composite TELRIC per minute cost that is three-and-a half times the FCC's upper price ceiling of $0.004, even when ignoring the two states with feature packages that include extraordinary features. These results confirm my conclusion in the *Original Trimble Affidavit* (at ¶¶ 17-20) that the FCC's local switching proxy price was based upon information that estimated the incremental cost of line-to-line or line-to-trunk basic switching, but did not, as the FCC's own methodology requires, include either the costs related to other switch features and functions, or common costs.

17. Exhibit 3 compares the FCC's proxy price for a combination of unbundled local switching and an unbundled local loop (*i.e.*, the reassembled equivalent of local service) to both the results of a GTE California ("GTEC") TELRIC study, and to current average revenues per line in California. To prepare this comparison, GTE derived the average monthly usage per line, including local and toll minutes of use, for an average of residence and business lines. This average number of minutes was multiplied by the FCC's proxy price ceiling of $0.004 per minute, and that switched usage revenue amount was added to the flat rate components that would also be needed to comprise reassembled local service (*i.e.*, a local loop and a Network [*11*] Interface Device, or "NID"). GTE also derived the current revenues per line for an average of California residence and business lines, including flat rate local charges, local and toll usage charges, and vertical feature charges. When the unbundled network elements of switching, a loop and a NID are combined to replicate local service, the revenues from those elements when priced at the FCC's proxy rates are approximately half of GTEC's TELRIC for the combined service (Exhibit 3, $18.88 compared to $36.35 per month). This comparison of price to cost understates the shortfall, because by definition TELRIC does not include an allocation of common costs. Further, the FCC's proxy prices would provide new entrants with approximately a 60 percent discount off GTEC's current average retail revenue per line in California (Exhibit 3, $18.88 compared to $46.31 per month). Clearly neither the FCC proxy price nor the TELRIC methodology come anywhere close to providing revenues that cover GTE's cost of providing service.

18. Moreover, the 60 percent discount that results from the FCC proxy price cannot be squared with the FCC's interim wholesale rates. Section 51.611 of the FCC's rules requires that

resale discounts should be "no more than 25 percent." Thus, the FCC's proposed requirements for its two pricing mechanisms (resale and unbundling) are totally inconsistent. The potential discount is significantly below the Company's costs and would result in GTE subsidizing competitive entry.

19. Based upon my review of the FCC's *First Report and Order* and the results of studies GTE has conducted using the FCC's own costing methodology, I am convinced that the FCC's proxy price ceilings for unbundled loops and local switching are significantly below the [*12*] cost of providing those network elements, and in absolute conflict with §§ 51.319(c)(1)(C), 51.503 and 51.505 of the FCC's rules.

[AT&T Logo]

(Infocenter Feature Story Intranet AT&T)

AT&T INVESTMENT
COMMUNITY MEETING

Transcript
March 3, 1997—AM Session

JOHN ZEGLIS: Okay, Thank you John. The subject is public policy. Like it or not, public policy still plays a very large role in AT&T's current operations and particularly its future aspirations. That's pretty much a function of where we've come from as a regulated utility. It's almost equally a function of where we want to go into regulated monopoly markets. It means we've had to seek a lot of change in the public policy arena. And my purpose here this morning is to persuade you that our program for this public policy work is not nearly as helter skelter as the briefs and counter briefs, charges and counter charges may make you think on a daily basis. We have structured our initiatives in the public policy arena around these four central strategic objectives. Number one, we need to eliminate the unnecessary regulation of AT&T. That means there has been too much of it and it's been lopsided against us and in favor of our competitors. Number two, we need to open monopoly markets to new entry. That means the local exchanges in the United States and just about any other country outside this country.

Number three, until we get those markets open, we need to enforce monopoly safeguards. The most celebrated here is clearly the MSJ like safeguard in the United States; no RBOC long-distance entry until their markets are competitive.

And then the fourth goal, also until we get those monopoly markets made competitive, is to use public policy to bring down this exorbitant 15 dollar carrier-to-carrier payment bill that we lug around? We call that access domestically and international settlement rates globally.

So the modus operandi for this talk is to look at those four objectives. We'll do all of them domestically first. We'll double back and do them internationally at the end.

We're going to talk about where we stand today, where we're going to go, what are the big plays this year and next, and in the end what kind of market framework can we deliver to AT&T for us to execute on our strategy.

All right. Number 1, deregulation of AT&T. This is the most fun because it's essentially done. We have had to seek this relief at two levels, state and federal. State as a practical matter we were done with long-distance regulation of our prices and earnings by the end of the 1980s. Further good news from the state, we're seeing no inclination to resume regulation of AT&T's new local service operations in a few of the states where nondominant by statute. In most of the others the commissions look like treating us for what we are. The second, third, fourth new entered with zero market share and not in need of any kind of traditional public utility regulation.

At the federal level, at the FCC this has been a tougher nut. And if you follow this, you know we've spent the 1990's peeling off the wraps a layer at a time.

The progression is also well-known to most of you. We've gone from rate of return to price caps to streamline tariffs to contract tariffs to nondominant domestically, to nondominant

internationally and now we're even up to de-tariffing. And now we've got an adjustment to make in the course as to whether that's mandatory or whether we can use tariffs where it makes sense. The point of it all is that AT&T, state and federal, has now escaped active regulation of our prices, our earnings and our services. Along the way we've thrown off some ancillary wraps having to do with the network disclosure, regulatory accounting rules, we've got a little mop up to do here. There is some bundling rules out of the old computer inquiry two, prohibition of equipment and services going together. We need to work off some safety nets, improve some deaveraging rules. None of that is seriously getting in our way right now. The asymmetric regulation is completely gone. We're the same as MCI, Sprint and the other long-distance companies. We're better than the local exchange carriers whose markets we're entering. Truth is we'll probably always be subject to regulations at some level. But this is pretty close to about what we want say that regulation on AT&T is no longer a significant constraint on our strategy or its execution.

So I think the thing to do is to get off of that one and go onto numbers 2 and 3. These are more interesting because they are work in progress and the involve some heavy lifting still for the company and the industry. Recognize that the numbers 2 and 3 here are two sides of the same coin, opening the local exchanges and prohibiting the RBOC long-distance entry until we do. And since February of 1996 this has been pretty much a story of the new Telecom Act. We're going to look at these two objectives separately. But we ought to also recognize the critical interdependency that the act created. Prior to 1996 we had a serious policy disconnect on these two objectives. You had Judge Green deciding on long-distance entry for the RBOC, but he couldn't touch the local exchanges. You had the State deciding on local exchange entry, but they couldn't do anything

about RBOC long-distance. And so the AT&T nightmare in all of this was that the MFJ relief would come out of sequence. That is, the courts would finish tearing down the MFJ and opening our long-distance market before the state had finished the job of opening the local. And that's why the 1996 act is such a great relief to us. It connected the two objectives, it commanded the opening of local first, and only then do the RBOCs come out into long-distance. And now we're engaged in the key to its implementation, namely we got to get the sequence correct so that the incentives stay in the right place.

All right. On that score, how are we doing? Well, I think as Bob told you, 1996 was the year of getting the rules in place for this new local entry. And our Congress dictated the order of events. The February Telecom Act gave us some standards. The FCC rule making in August gave us some more. Carrier negotiations in the spring and summer were to iron out some of the wrinkles and we were to go to the state commissions for arbitration for the final rules in the fall and winter. We had a surprise along the way, known as the 8th Circuit Court of Appeals. Got that stay in October and we're looking for a decision in April or May. But as it's turned out that may not be as important as we first thought, because the pace of decision-making, the number of decisions and especially their content in the hands of the state has worked out almost exactly as we expected and more importantly as we hoped for. So we're going to take a look at that now. And I want to tell you we're going to use a coverage metric here that goes by access lines. That recognizes that a decision in a small state isn't as valuable to us as a decision in a large state. And it begins by showing you that we have 98 percent of the access lines covered by either final negotiations in arbitrations or those that are in progress. We've done 81 percent complete. That comes out of nearly 50 arbitrations and that covers 120 million lines. We're

going to finish up another 17 percent in 1997. That's some 30 odd arbitrations over 25 million lines. The two percent there are either exempt rural local exchange carriers or places we don't think we need to be.

About half of that solid blue is on appeal to the district court. Frankly I think we'll make it all of the blue on one side or the other.

And only eight of those arbitrations are actually resulted in signed agreements with AT&T. That's because after you get the decision, you are sent back to the bargaining table to implement principles and to finish the details, not always a quick task.

All right. If that's our coverage, how about our results? Well, the most celebrated issue in these arbitrations is always reselling. Reselling all or a piece of the local exchange carriers's services and networks. And there are two ways to resell under the act. One is the total service, that's what we call total service resale, TSR. And let's look at this one first because the act gave us the formula for the wholesale discount. It said you take the RBOC or the nonRBOC retail price back out of voided costs and properly applied to the FCC that ought to bring you out roughly in a range of 17 to 25 percent. How did we do here? First the RBOC territory. Terrific results, 91 percent of those lines are in or better than the FCC range. We're 102 million lines covered within that proxy range or a little better.

We've got five percent of six million line underneath it. Utah, with seven or eight percent on the resale discount. And if you look at how these things distribute, you would see that we've got a major cluster there in the 20 to 22 percent range, and way

out there on the right, take a bow to the national champion, the District of Columbia has a discount rate of 31.4 percent.

Quickly into GTE territory we've got another story going here. We have 52 percent of GTE lines where we've litigated in that discount range. 44 percent of the time we're out of it. That's about 7 million lines. If you live in California, Florida, Oklahoma, Ohio, you ought to be embarrassed.

Another way to resell, and one that figures prominently in our plans, is what we've been calling the unbundled network element. And here if anything we've got a better story coming out of the arbitration. First, everybody who has addressed this issue everywhere is giving us the full unbundling that the FCC called for in its August interconnect order. That means we can get at the elements, at the features and the functions and the ILEC network piecemeal. That includes the vertical features of the switch. We can pick and choose what we need.

Second piece of real good news. Not only can we have them individually, we can buy the elements, put them all back together, create local service out of it, something we call the unbundled network element platform, UNE P. If you can remember that we'll speed up the presentation. But 92 percent of the lines coming out of these arbitrations are eligible for recombination in the way I described, and we will be appealing intensely Georgia, Tennessee, Louisiana and Alabama, where it is not permitted. Nice work Bell South, but you're going to get reversed.

All right. Next issue, what price for these unbundled elements? Well, more good news. Most of the decisions have come out in favor of a pricing methodology that uses long-run incremental forward looking costs. There area few hybrids in the mix, but

the nice part of this is no decision uses the embedded backward looking costs to price these network elements. Again, how are we doing? RBOCs first. We have 94 percent of the RBOC arbitrated lines covered by that forward looking cost methodology, and when you put that methodology on to the costs and the elements in the RBOC territory, it turns out that something like 74 percent of the prices- this is loop prices- come out near or below what the FCC estimated would be the case when it issued its August order. These are called proxy prices and they were guesstimates based upon what the forward looking cost methodology would produce. Better pause and acknowledge the national champion, Illinois. 43 percent of the FCC loop proxy. You can get a loop in downtown Chicago for $3.72 a month.

Again, GTE, a little different, this is kind of an amazing story. We have 81 percent of those GTE lines have been arbitrated to use the forward looking cost methodology. Let's put that cost methodology on the actual cost, going forward, and what do we get? Wow. Only 28 percent of the lines fall within that FCC proxy projection, something like 60 odd percent of the lines are outside it, makes you wonder whether they really are high cost. Also going to have to do something about some attempts to put non-recurring charges on us when we win customers in this manner. Those aren't cost based and we're in the process early this year of litigating any such charges back to cost.

Good news I guess is that the business case for using this unbundled platform is going to turn out to be a lot less sensitive to the pricing results than TSR. And that's where I want to move next. I would like to line up for you the economics of TSR on the one hand and the unbundled network elements on the other hand in AT&T's strategy and business case.

We're going to start in the State of Pennsylvania, where like other places, TSR margins are modest. This is a good state for us. This is one where our wholesale discount is 25.9 percent. And when you stack the revenue next to the cost, you see that for a consumer averaging 20 dollars of local exchange service in Pennsylvania, we have a cost of goods sold of $14.81. Gives you a chance to market a combined local and long-distance package to this customer, gives you a fighting chance perhaps of recovering your marketing and billing and customer care costs incrementally to what you're already doing for long-distance. But it's tight. I guess what you say is it's a lot better than is used to be in Rochester where on that trial we have began to a five percent discount and the pink stack would have been 19 bucks.

But now let's look at the unbundled network element platform in the same state. We'll stay in Pennsylvania. Admit it's a good state for us. We're going to go into a high density, low UNE price zone. We're going to buy all the elements, recombine them to make global service out of the elements and assume we're doing this to a consumer that buys $25 of long-distance and five dollars of local toll service per month. And now what we end up with, stacked next to it, is quite a different picture. Our cost of goods sold on that platform is $16.03, slightly above the TSR cost. But our revenue is $33.50. Consisting of that same 20 dollars in local that we collect and $3.50 in the interstate subscriber line charge, which under FCC rule comes to the provider under the platform, and 10 dollars worth of access, which was otherwise being paid to the local carrier on the 30 dollars of toll this customer was using. So we have widened our margin on the UNE P by more than twelve bucks over what we had on the TSR side.

Where this company assigns this margin, how you assess this business opportunity, depends on what business you think we're in at AT&T. If you're a division that thinks your business is local exchange service, that is, you're after the 20 dollars, then you say, wow, I've got an all in, net cost of service that is defrayed by that extra revenue I collected, taking that away from the 16 dollars, I'm not paying more that 2 and a half dollars all in for the cost of goods sold to let me go chase the 20 dollars.

A little more accurate way of looking at our local business might say it's not local exchange. It's local network. We're going to change all the revenues that move over local network facilities. In that case I just bought a $33.50 revenue screen for $16.03 cost of goods sold, a discount of 52 percent. Or if you're in one of our sister divisions, say Gail McGovern's consumer long-distance, she might look at it differently. She might say, Good. For the same $16 that Harry Bennett paid to earn his 23.50 of end user collection, I just had my access reduced by $10. I improved my margin on a $30 toll customer by $10 because I don't have to pay access anymore outside the company. And Harry still has the distance between 16 dollars and 23.50 to recover his further costs, which is a 32 percent discount in and of itself. Or if you're Bob Allen you say, I don't care how you all allocate those costs among the divisions, it's all mine. And what I see is a 53.50 cent revenue screen, we saved 30 dollars of toll revenue, we add 23.50 of local revenue, and we traded that crushing permanent access cost for a platform cost, plus a little bit of intercity transport cost represented by those yellow dots.

None of this by the way is to say that we can't make some business out of the TSR side of it. On the TSR side, you still have some very attractive long-distance customers, in this case

the same $30 toll customer stacked up on top of that local revenue and that local cost. But now you're still paying access, which is why the pink bar goes up as much as it does. And you've lost your opportunity at 3.50 cents for the subscriber line connection recovery. Just another way of showing that your 13.50 better off on the right-hand side then you are on the left-hand side. And you know, this can go on for a long time. We could really have fun. How about a 75 dollar toll customer with 5 dollars of intrastate, intra-LATA toll? Now you move your cost of goods up to 19 dollars but you move your true local collections to 50. I'm dealing with a 64 percent discount, as you see, the higher the toll usage the more pronounced advantage of this platform. And you've got lots of room in there for some sensitivity around the existing costs and prices of the platform.

Having said all that, I want to suggest that none of this is the right way to look at the new AT&T's business. We are more than an all distance business. On top of that all distance stack of revenue we intend to add Internet service, information services, we intend to add anything that requires local connectivity. And we can do it without adding local connectivity costs. It's simply a matter of putting a couple extra pennies on the transport, but the basic connectivity platform stays there in the solid pink. It makes you look at our business in a different way. It's a two-fold business. We're local connectivity and it platform costs and anything and everything that comes after that connectivity.

Clearly there are huge advantages to that kind of business when you use the unbundled platform. It makes that local all distance service much more attractive, makes us indifferent to what happens in access for Interest, gives us an outlet for the new services, let's us work down the pink costs by replacing the

RBOC elements with our own switch or our own wireless loop when the economists say so or when we want to differentiate our services. Frankly, all of us, you and the business are probably going to have to work on a different way to keep score. We aren't going to be able to allocate that connectivity cost among our businesses any more decisively and definitively than we've been able to allocate the cost of the local loop for 125 years in the industry.

Look, with all that opportunity, what are the public policy threats to AT&T's going forward business? One I hear most asked about is the eighth circuit. And sure some national uniformity would be useful if we can get the FCC's jurisdiction restored in that appeal. But most of us are lot less concerned than we used to be about what's going to come out of St. Louis. The first piece of the business model we've been looking at here, rest on the unbundling of network elements. And that's something that congress built into the new Telecom Act. That's not something the courts can say we don't want. Congress said, you got to have unbundling. So that's the law. And we feel pretty secure about that one.

The second piece of this model depends importantly on a principle that says, you don't pay access if you provide service over an unbundled element platform. Again, that's within the FCC's interstate access jurisdiction. That isn't a local entry matter. Probably that's not even properly before the 8th circuit right now. At least to the 70 percent of access that is interstate. And by the way, the 30 percent that is intrastate so far most of the states with only a few exceptions have gone along with the FCC rule and said no, you don't select intrastate access either when you're providing a platform and not a per minute connection charge.

So what we ended up with in the 8th circuit was a lot of arguments over jurisdiction; fed or state. That state as it turns out did just fine without that preemptive federal jurisdiction. Perhaps it was seeing those results, perhaps it was doing the math on the platform. But the exchange carriers in the full argument added some substantive pricing challenges to their appeal. They say you can't use the combined elements for local, you can't use the forward-looking costs. That's unconstitutional or prohibited by the statute. It wouldn't be serious, at least more serious if we got a reversal on those grounds. But frankly the states did not join those challenges. The bulk of the argument has been on jurisdiction and we feel good about our chances on the substantive issues in the appeal.

Let me say here the biggest threat to this kind of business plan isn't public policy directly. The biggest threat is really implementation. Can we get at this stuff? Can we order it? Can the local exchange carriers provision it? What we have, incidentally, are the commissions doing their part again. 95 percent of the access lines are subject to orders that the local exchange carrier provide us with electronic interfaces for ordering and provisioning the elements and the service. Not only automated but at parity with the way the LEC provisions its own customers, through its own systems. We're getting the right rules in place about this, too, in the regulatory arena, but are the exchange carriers ever going to get us up and running? Well, we would say that depends in the first instance on incentive. And to show you the advantage of getting the incentives right, we have to turn to the sad case of GTE, which illustrates the point for any nonRBOC territory. The Telecom Act didn't get it quite right here. They left GTE free to get into the long-distance business, even as it continues its local exchange monopolies, and they are accumulating customers rapidly. They have got no incentives to cooperate with anybody

else in getting those exchanges open. Quite the contrary, the longer they're closed the better it is. They're the most active challenger of the Telecom Act. They have some of the highest access rates, some of the highest element prices, some of the slowest implementation on the entry conditions. Frankly, we've got to do more than we're doing. At the moment we're waiting for the Telecom regulatory processes under the act to play out before we look at testing the that kind of behavior elsewhere, such as in the antitrust courts.

Are the RBOCs doing it any better? After all, these are the ones that have the incentives in the right place. How well can they be expected to perform? I tell you that's going to send us over to the third objective, which is to assure that we don't have long-distance entry before the RBOCs open those exchanges realistically.

This is a subject where the industry has spent a lot of words without necessarily advancing knowledge. So I'm going to try to stick to what we do know about RBOC entry. And it starts here. We know under the new act this is a four hurdle race, and these are the hurdles. First, you have to implement the local entry checklist, fully implement. Second, you've got to be facing some actual facilities competition for both business and residence customers. Then you've got to submit to a DOJ evaluation of conditions. And finally, you have to win the FCC's determinations that your entry to long-distance is in the public interest.

Now, three out of four of these hurdles, B, C and D, remain very speculative. How much competition is going to be required out there? We say, nontrivial, everybody agrees. But you can't really look to the act to define it because it didn't.

What DOJ test is going to be used in their evaluation? We hope it's like the MFJ, that it starts with an analysis of whether there is uncontrolled market power locally. How is the FCC going to weigh the public interest factors? We think that the FCC recognizes how important incentives are and how undermining it would be if premature entries were allowed to reverse the incentives. But at this stage, who knows. All I can do is argue the case and I'm not going to do it right now.

That's why we are spending most of our time working the first issue, the checklist. The checklist is much more granular. We know what it is. We know that it's not just an agreement to do it. It's not just a theoretic availability out there. It needs to be fully implemented. Those are the words of the Telecom Act.

For some of the conditions in that checklist, you get an obvious yes, no. The RBOCs know how to do it and you know when it's been done. It's like dial parity or number portability.

Others are just as important but they're proving a lot more difficult for both sides. And chief among these difficult items are these operating systems for ordering the TSR and the unbundled platform. This has shown up in the industry as a huge problem.

Automated TSR ordering right now is in the early stages. It's only a very few states. Automated unbundled element platform ordering is up and running in no state. Not a single state met the FCC's January 1, 1997 deadline for having the interfaces operational.

We are focusing the PUCs, the FCC, the DOJ on these issues. We're trying to establish metrics and standards where none exist. We've supported the creating of an industry coalition to

attempt consensus on a set of quantitative measures that are based on really very common sense business needs. Can we order the stuff automatically? Will the exchange carrier accept the orders in the quantity we submit? Those the customer get service on time? Is the billing accurate? Does the service work? Can you get it fixed? Our view of success here is almost exactly what FCC chairman Reed Hundt told the state commissioner in November of last year. Provisioning limits must not materially limit the flow of customers from the BOC to its rivals. And folks, the systems do that right now you're going to hear more about it tomorrow from our local service panel. For me, you're going to hear that having said all of what I just said, I still can't answer what you would most want to know about this issue. When do the RBOCs get in? Most of it, please recognize is out of AT&T's control. We don't do the checklist compliance, they do. We don't make the public interest determination, FCC does. I can tell you the FCC and the PUC appear to be deadly serious about this. Ameritech Michigan demonstrates that. Ameritech relied on an unsigned AT&T agreement to show that the checklist was available. They didn't get to first base becasue you must actually be providing service under a signed agreement and neither of those conditions was true. Our position will be steadfast, fully implement that checklist, make big progress on access reform and show genuine competition and choice in your state. What does it mean for 1997 entry? I will say that on the current track no RBOC in our opinion is likely to meet the checklist and show enough competition to qualify for long-distance. They shouldn't get in.

Nonetheless, we've been promised a wave of applications in the second quarter of this year. Nobody ought to build a business on my prediction. So the prudent thing for us all to do is to be

prepared just in case some of those applications slip through the net and we get premature entry.

I promise not to talk beyond what I know on RBOC entry. That's it, new subject, access.

This is a large dollar issue for AT&T. Domestically, which is what we'll take first, we're looking at somewhere between a 12 to 13 billion dollar bill. Our historical record on driving down access through public policy is good. I might even say great. There is a twelve year history. And through a series of regulatory interventions and some smart network optimizing moves, we have moved the cost of access, conversation minutes, both ends, from 18 cents right after divestiture down to five cents on average right now. Even better, you will see that in 1995, the blue AT&T and the red everybody else crossed over, and we now enjoy a slight advantage over our competitors in regard to interexchange access.

But as we assess it, the traditional methods that got us that slope are beginning to run out of gas and still switched access is overpriced by seven or eight times. The local exchange carriers are collecting billions from the interexchange industry. The access charge has disguised the true cost of the service. They deliver a mass of undifferentiated subsidy that's impossible to target and it leaves the local exchange carriers with billions to turn right back on us in their competition in the future. For at least some of those reasons the 1996 act calls for reform. It demanded that any subsidies in these collections be made explicit, that funding be made competitively neutral, and that in our opinion anyway, charges for access be cost based. And that's why we're now in the midst of a very large FCC proceeding on reforming the traditional system. And I'm going to show you how AT&T argues its case in that proceeding.

Let's stay on the left stack, if you would, please.

I'm going to leave out the subscriber line charges. The exchange carriers collect something on the order of 7 billion directly from end users. The stack on the left is what the interexchange industry pays. And as we make it, starting from the bottom, there are to the nearest half billion we'll say there is two and a half billion of special access charges. These are dedicated circuits. Based on our idea of forward looking cost, there is another two and a half billion of actual cost based switched access in the stack. Then we would allow that for legitimate targeted universal service support, there needs to be another five billion dollars somewhere in the industry. And all the rest, another ten billion dollars or so, is excess. We're going to call that subscriber line overpricing SLOP. So we've got ten billion of SLOP in the system. Our ideal income is the middle column. Our ideal outcome is the middle column. We'll sign up to pay dedicated access on roughly the cost causative basis that's now charged. We will pay on whatever rate structure makes sense the two and a half billion of switched access that we use, actually related to cost. We'll pay our part of the yellow, the universal service subsidy, although we think that under the act, the tax base here needs to be expanded. And that when we get some additional payors in the next- the yellow should go down at least somewhat as a burden on the interexchange industry. And the SLOP just ought to go away. It's excess. It doesn't relate to cost based pricing and its not needed for universal service support. It's just needed to cover inefficiency or what have you. And in consequence, we will flow it through in our long-distance charges, but in the end, the interexchange industry will be relieved of more than $10 billion worth of the burden that we now pay in our access charges.

Okay. That's what we argue. Realistically, as we come near the end of this proceeding, we have to acknowledge that it may not happen. A lot of people think that is too radical a move. Other people think it puts too much pressure on local rates. Not to worry. We are working a strategy that allows us to win under other combinations of reform which are out there in the right-hand column as a for instance.

First and foremost in that strategy is to make the access charges portable. Whoever wins the customer collection the access. That was the basis for the UNE P demonstration we went through. If you're a facility based carrier or a platform competitor, you don't pay act sells to the LEC. You collect it. Same for the subscriber line charge. You collect it, not the LEC from the end user. And if you're serving one of the supported subsidized customers, you collect the subsidy, too. Your share of the yellow. That is in fact what the FCC is now denominating incorrectly the market forces approach, but it is in their sights and frankly we have won the portability once in the local interconnect order. We feel good about that part of the strategy.

Second piece of the strategy, if you don't take ten billion of SLOP out, at least take a large portion out. Everybody agrees we're not paying cost based access charges. A minute of access is the same as a minute of local service and we know from those arbitrations that that minute costs less than half a cent, not the two and a half or three or four or five that we're being charged in access. How would you get some of that SLOP out there? I suppose you could raise the subscriber line charge or you could just have the RBOC suck it up and take it and look for more efficiencies. We might even see the FCC putting what's left of the SLOP on a per line charge to the interexchange

carriers. But our position maintains - or continues to insist on a very large bouyant ante to the SLOP reduction.

Finall the third part of the strategy is surcharge for the subsidy for the yellow segment, whatever it is. We acknowledge here it might even go up. We're adding schools and libraries and rural health care facilities to the mix of supported customers under the new act. But even though it goes up or might go up, we could use some more payors like the RBOCs who collect the slick and have interstate corridor traffic and most importantly make it explicit and make it competitively neutral. That's what a surcharge on all carrier's revenues would do. We won't then end up with a relative disadvantage at AT&T.

When that's all said and done, and whatever combination of elements you get in the right-hand stack, here is what we think it's going to mean. To the industry, we think that all the put and takes are going to leave us with something less than the 20 billion dollars of burden we now carry around. For AT&T, on one day, we expect to be recovering any subsidy as an excise tax like charge on the bottom of the bill. We expect to be recovering any per line assessments against us right back as a per line assessment on customers. And we expect that due to some structural shifts and some outright SLOP reduction, our per minute access rate therefore will decline, and even as the market pushes that through to lower long-distance prices, we'll be benefiting from a handsome piece of stimulation on calling.

That's day one. On day two, I hope by now our strategy is clear. Starting on day two, we play the unbundled element platform game. We win our share of whatever stack is left as we win the customer on our platform or on our own facilities.

We'll know a lot more there in a couple months.

Let's now go to global. Double back on those principal policy objectives. Declare number one not an issue outside the country.

Alas, we don't have enough of a presence to bring down any regulation on us beyond our borders. Let's recognize we've been working outside the United States and inside for that matter on numbers 2, 3, and 4 in the same way as we have been working for domestic markets. What result? Mixed. As to opening none US markets, the track record is not great. As to preventing PTT entry here until the whole market is open, no better than spotty. As to lowering access costs which are settlements in international parlance, better. A lot better. We do very well here. But it's drudgery. It is working through bilateral negotiations one at a time.

What we are looking at this will season in this international policy work is a break through in all three objectives, which is the cause of a double play with the GATS trade agreement on the one side and the proposed FCC benchmark order on international settlement rates playing on the other side.

Let's take a quick look at the first part of that play. What GATS did for us is acquire commitments kicking in no later than the year 2000 to open markets covering 90 percent of the world's telecom revenues outside the United States. This shows you the whole world after GATS. The 35 percent U.S. we've always counted as open. Then there is another 45 percent of the world that just got committed to what we call full offers. That means that the countries commit to enforceable entry conditions. They eliminate ownership and control restrictions on second and third carriers, and they allow international facilities competition. Then there are 14 percent of the world's revenues, 44 countries, that gave us partial offers,

meaning that one of those three elements of competition I just named is missing or partially missing. Here you get countries like Mexico and Canada because they insist that ownership cannot rise above 49 percent. And then the last six percent of the world's revenues are those 60 odd small world trade organization countries, as well as China and Russia who are not members of the WTO.

What this represents to AT&T is a lot of opportunity. I would emphasize it as opportunity beyond having to set up intracountry telecom businesses with all the expense and investment that goes there. We have new opportunities here, such as the ability to terminate our outbound calling through competitive modes that are going to spring up in these newly opened countries and thus avoid we hope some of those high settlement rates. We also have an opportunity to do truly world telecom networking. Maybe hubbing through the United States. Moving traffic from country A to country F through the U.S., becoming to telecom what Atlanta is to air travel in the southeast.

The thing that let's us support GATS with this kind of fervor is that companion piece I mentioned, this proposed benchmark order for international settlement rates coming down from the FCC. That aims to move these high rates down, and it provides a protection for AT&T as well as opportunity. The reason we need protection is it's going to take some time for these GATS opening to take hold and show up in competitive market openings and gateways into countries. Meanwhile we're going to go on without some regulatory intervention, paying these very high settlement rates on our outbound traffic into those countries. Think of it as terminating access. Sure we make some back at the same level on the return traffic, but we are vulnerable to losing that kind of return profit if a PT and T

comes over here and sets up sub or strikes a sweet heart deal and diverts its inbound traffic to its favorite carrier.

The benchmark order, if properly implemented, would by and large give us some insulation from that. Here is what's happening as the FCC is tentatively proposing it. The FCC divides the world into these three categories of countries. High income, middle income, low income. It says to the world, you are outrageously high above cost existing rates there in the red bars, pink bars for each of the countries. Need to come down to a benchmark zone which has six to nine percent- six to nine cents per minute at the bottom. I've averaged it here as seven and a half. And a different top end of the zone, depending on whether you're high, middle and low. What's more, we'll let you implement on different schedules. We'll give you one year for the high income countries, two for the middle and four for the low income countries.

And what that's going to do again is reduce the terminating access we pay to the foreign countries. It will also reduce the access we collect on the incoming traffic. But because we have so much more traffic out than in, that increased profitability outbound and more that offset the reduced collections on the inbound. And we aren't threatened anymore by the incoming traffic diversion. At cost in fact we're absolutely indifferent.

Now, besides protection of the existing revenue streams, there is a lot of room to make money in this game, because of our net outbound traffic advantage. And we're going to try to show it to you this way. Up there on the top, the horizontal bar is what we're paying in 1996 net for international settlements for our top 65 countries which cover about 80 percent of our international revenue stream. About two and a half billion dollars.

Now, if you go to the middle downsloping line, if over a five-year period we pay outbound at the high end of the FCC benchmark and collect that same rate coming back in, we save a billion six hundred million on what we currently pay net to terminate our traffic overseas. If we go to the low end of the FCC benchmark range, we pay seven and a half out and collect seven and a half back, we're going to have 2 billion. And something we don't like to think about, but if it's asymmetric and we pay the high out and the low in, then you're on the pink line and we've still got more than a billion dollars of savings. Indeed if we have to pass the better part of that through to end user rates, we still think there is massive stimulation left in these long-distance rates overseas which have been too high because of these inflated settlement costs.

I guess the point is that we have a lot of room below that yellow line to accommodate even an uneven implementation of the benchmark order and some GATS delays before this would ever float above that line. There is clearly much more opportunity here for AT&T than there is risk.

In fact, I got to say, in this scenario, the place to be is in AT&T's shoes. We're already competitive in the United States. We know how to compete. We're going to have new opportunity in other people's monopoly markets. We've got more outbound traffic than in. We've got access coming down. The place not to be is one of them. The monopoly PTT. Your market is about to be attacked for the first time and the mother's milk of excessive settlements is about to be taken from you.

So I can't wait for this game to begin.

Look, opportunity after opportunity. I'm going to stop with that. I want to wind up by saying we are winning these

opportunities now because our public policy positions are lined up with customers. Giving customers more choice and more value.

After a lot of thought and more importantly after years of losing public policy fights on the other side of the equation, I can tell you that in a prepluralistic society, it's the customer friendly position that wins the contest in the public policy arena. And with that as our touch stone, ladies and gentlemen, and with our business lined up behind it, we're winning not just opportunity out there, but we're winning positions that let us be ultimate winners no matter how some of the uncertainty breaks around the fringes of these proceedings. We are creating frameworks for opening huge new markets here and there. I'll tell you for years we're going to be enforcing those rules as we break down the existing monopolies. But I'll also tell you that for the first time I think we see the day when the regulatory obstacles are not limiting AT&T's opportunities.

Soon we're not even going to need fundamental change out there in public policy. We're just going to need the enforcement of the frameworks that we're setting up right now. So in this public policy world, in this mystical world of regulatory work, I can assure you that AT&T has gone on the offense. We're there now and forever more. So thank you very much and we'll start with your questions if you have any.

A SPEAKER: John, let's take the worst case out of the 8th circuit and ultimately the Supreme Court, lets say rebundling does not live. How much investment would AT&T have to make in switches or other elements to still be able to get those kinds of financial results? And how long would it take you to get the pieces out in the field to be able to get those kinds of results?

JOHN ZEGLIS: I'm going to give the nonanswer. I cannot think of bundling falling in the 8th Circuit in the Supreme Court when it's already commanded as a matter of the Telecom Act of '96. Pricing, sure that's an issue, but not unbundling itself. But rebundling? Rebundling, once we provide the service on a platform we are not going to pay the access because that's a matter of the FCC interstate access juridiction. What we are seeing in rebundling challenges is the state saying, Georgia is a good example, if you rebundle the platform you have to pay TSR rate, not the unbundled elements rate. So if you have got the elements but had to pay the TSR rate and didn't have to pay anything extra fo the additional elements, then the increment is just between the TSR all end price for local, and whatever the unbundled elements price might have been. If you have to pay additional element prices on top of your TSR, we haven't run the numbers on that, and I'm going to defer any elaboration on that question to Harry Bennett, who can also give you tomorrow some scope of what the investment might look like, but it is not within our plans.

A SPEAKER: My understanding is in places like Louisiana you basically would only have to throw in operator services or one item in order to get the unbundled rate, and that's a used profitability issue. My question is, what does it take for you to do that everywhere?

JOHN ZEGLIS: I don't know. But I will seize on your remark, this is what we call N against N minus 1, even places that we can't use the entire recombined platform in those very few jurisdictions, if we add one element, all their elements minus 1, then I believe we still get platform prices and not into TSR mode. Yes?

A SPEAKER: My understanding is that many of the states' orders are actually interim orders, I'm wondering to what degree there is risk when the final orders are issued, it's not as good as it looks right now and also if you could articulate how many are-

JOHN ZEGLIS: I'm going to go to extended panel to give you exact numbers. I'll tell you that my opinion, having watched this, is we stand to gain probably as much on finishing off the unfinal orders as we stand to lose as in the case of Utah, which said that was a temporary rate, that was in the case of California, which they said they would come back to the rates for GTE in a 1997 proceeding. And as in the case of any nonrecurring noncost base charges, which we want a second bite at the apple for. As to how many of the solid blue, gentlemen, the '82 access lines covered are still subject to some further dealings in the state commissions we are going to give you our Chief of Staff to the local service division, our major dome in government affairs in the state.

A SPEAKER: We have 27 decisions today of which I think four or six are final, eleven are interim. Our expectation is, our prior history is the results in final tend to be a little bit better than even the results in the interim. We are very very confident. Using John's paradigm of access lines, I think it breaks out in the 80s for final and the low teens, if at all, in the teens, on the interim, so we feel pretty good about where we stand today.

Just to follow up, if I might, John, on the question over here about minus 1, we had a lot of success with the 1 being operator services and DA in our arbitrations and our expectations are that if it does not turn out to be N minus 1, we feel good about the opportunities, given our OS platforms.

A SPEAKER: Rick, Goldman Sachs. You said you didn't want to speculate on RBOC long-distance entry, but I'm going to ask you anyway. Could you, in light of the fact that the famous 13 words that you tried to get put into the bill did not get there, and you used the phrase the sequential and other carriers used sequential, the Bells of course all it simultaneous and I guees I'm just trying to ask, you know, your sense on the timing and where you see the sticky points going forward, particularly for BC and B, which you said were less specific.

JOHN ZEGLIS: Well, I stand on a lock on sequential, you can't have simultaneous if the requirement is to have the checklist fully implemented, an agreement under which the competing carrier is providing service and actual facilities competition running out there in both the business and residence markets. I know there is an issue here of rhetoric about simultaneous and sequential, but I think we have got that one knocked in the act.

Now as to the missing 13 words, what we are referring to here was a description of how much facility build-out there had to be, and it was like comparable to the exchange carriers' own operations in the state. That was not in the final version. It was taken out because of a misguided fear in our opinion that that meant a state-wide over-build, one for one as into every home and business in the nation. And we were assured at the time that nobody with a full deck would think that that means one loop or one switch, obviously we are looking for nontrivial, local facilities competition significant enough that it puts checks on unrestrained monopoly pricing that the carriers might otherwise use. That's why I say it's very hard at this moment to get into how much more than nontrivial is required and less than a full state-wide build-out.

A SPEAKER: If it is trivial becuase I'm guessing-

JOHN ZEGLIS: Nontrivial.

A SPEAKER: If it is a trivial degree of competition, a year or two years from now, is it the FCC or the DOJ or the state that you see standing in your way?

JOHN ZEGLIS: I think they're all standing in the way of the RBOCs.

A SPEAKER: Right.

JOHN ZEGLIS: They all get a bite of the apple. The state starts by affirming the checklist is implemented, that all of these checklist conditions are being provided pursuant to a signed agreement to a competing carrier. Probably they do a lot less on the extent of competition than the other two. DOJ, I think they are going to look at it. That's been their bent now for 15, 20 years. So you will get a look-see by the Justice Department, but they don't make the decision. They render an opinion which has to be given substantial weight at the FCC. Your question in some respects is easier than my answer. The FCC makes the final determination on that one with the state and DOJ. Who has got a mike?

A SPEAKER: A few weeks ago Bob Allen said access charges savings would be passed through to customers; is this a policy that you are actually promoting publicly in regulatory form? And the second questions is, John Walter spoke about best in class cost position. And what you showed us was about cost reductions but didn't talk about how other competitors might be positioned differently. For example, what will the BT/ MCI

merger impact on cost relative to perhaps eliminate settlement and hubbing between those two companies?

JOHN ZEGLIS: The access flow through commitment is probably not our policy, it's a regulatory policy. That is to say we are at a point now where in order to get fundamental change and relief from that burden we are going to have to give the flow-through as the quid pro quo to get it. How much of an additional commitment that is over market which has required us to to flow access and more through every year for the last 12 years, I don't know, but you get the drift there of my opinion.

As to cost advantages, on the access I think was your question. BT/ MCI was your choice, we also worry about things like NYNEX, Bell Atlantic, and the cost advantage we worry about is not our access against long distance companies access, it's the two-ended access advantage or even a one-ended access advantage that a carrier gets when it both supplies its own access and charges it, so the left pocket -right pocket transfer to us is a chance to squeeze by bidding up access and bidding down retail.

The answers are we are very concerned about that when you are dealing with local exchange carriers here, especially when you are in their regions. Traffic for both ends of the call, like NYNEX and Bell Atlantic, would expand a lot of territory to become subject to that. You have exactly the same thing going on with BT/ MCI, although it's one ended it's in Britain, so yes, we are worried, yes, we are in the FCC, it's a condition to closing merger. They need to bring the settlement rate down, from the existing 11 cents to the bottom of the FCC rate, 6 cents, which we think is close to the cost of access in Britain.

A SPEAKER: Basically between those two, can't BT/ MCI say we are going to do a paper transfer of money in essence making it zero, which says you are not the best in class, especially if they begin hubbing?

JOHN ZEGLIS: On this we won't have access until MCI metro substitutes all the lines, they have the same problem we do. On the other side they have the advantage of having it in their own enterprise. Unless we request, get access to the access, at cost, which is what we think 5 cents might yield. Yes, we worry that they will have that advantage and they can use it to price squeeze. So to get the answer down so they don't have room to price squeeze us since it's cost to both of us.

A SPEAKER: Todd Jacobs. You made the compelling case about the application of the FCC benchmarks reducing your settlement costs over the next five years. I assume that was using static minutes?

JOHN ZEGLIS: The same minutes that produced the 2 and a half billion.

A SPEAKER: My question is, isn't the risk to international information the risk - for the next- first time as opposed to the last ten years or 15 years, that prices could fall just as fast, if not faster, than settlement rates, given new networks springing up internationally, new placings to land traffic, you said the probability of sweetheart deals with local subsidiary networks in the U.S., et cetera, what's the risk that if the international calls have too much profit per minute built in that could be coming down over the next five years?

JOHN ZEGLIS: I think two risks. The one I spoke to was that our profit on a current international call that we earn from a

U.S. subscriber outbound comes in two bites, one is what we collect minus what we pay, netted against what we collect from the incoming when the call comes to us as part of our proportionate return from that PT and T. What we are working on through the settlement case here is to make us indifferent to whether we get whip-sawed or traffic diverted disproportionate return. That at least puts us in control of our own destiny, we win the outbound call, we win the profit and we don't save all to somebody else's idea of return traffic diversion. I think, I think the benchmark settlement order and the FCC's rules against whip-sawing until it is in place.

The second part of your question I think is market, when we do get these down and in control of our destiny, what about margin of outbound calls, aren't we all going to have a go at lower prices to earn more customers? And for that we look forward to Gail McGovern and Jeff Weitzen's answers this afternoon on their panels.

A SPEAKER: Yes, a question. What is your view of three-way mergers of RBOCs? And secondly, your chart shows like 4 billion of access reduction on the right-hand side, which I guess was your compromise solution. Is that instantaneous or over time? How do you look at that? What do you think is the really most likely on access charge reform?

JOHN ZEGLIS: All right. My view on three-way mergers of RBOCs first is if they eliminate competition, potential competition in local Bells like NYNEX and Bell Atlantic threatens to, that three-way is worse than two-way. In addition, it will give more opportunity to price squeeze us on both ends of a call because three-way mergers will have more intracompany calling than two-way mergers have, so if it's bad in two-way for the reasons we have suggested at NYNEX, Bell

Atlantic, it's worse in three-way. Now, on the access reduction, the right-hand chart was over there, so that you wouldn't draw a line back and get any estimate on what we expect to have. That was just to show lower than what we pay now and higher than Nirvana. As to any predictions on how this might come out, I'm going to let Jerry, our senior officer, shepherding the FCC in our Washington operation, add any refinements he wishes to or give a no comment. Your choice, Jerry.

A SPEAKER: I would like no comments, but let me try for a minute. We really think there are three ways we can win with access charges; one, you get immediate reduction and the SLOP is taken out of the system, which is right public policy. Again in line with what the consumers deserve.

Second, a significant initial reduction. We have identified on record to the FCC a number of ways in which using the current proceeding, the current record, before the commission, that they could reduce over 4 billion in access charges immediately. Those include just taking retail end user charges off the general support facility charges which are embedded inappropriately in access charges by redefining the cost of capital, which is part of the price cap proceeding, so we do believe there is ample opportunity for the commission to right now reduce access charges significantly tied to that, also as you move cost explicitly to the end user, as you would with universal service charges, as you would with some of the per line charges and some of the other end user charges that could be put on the bill, you are reducing per minute access rates significantly. Again that is beneficial to the company.

And the third way we win that, John I think explained very well, was the unbundled elements platform. We don't pay access when we use the unbundled elements platform, if the

FCC is consistent with what they said thus far. We are in a good position in access charges both on the FCC order on the 251 order did spell out what John said they are on the record before the Court, before the FCC is already making those determinations; and second on the pricing methodology they already looked for the pricing to be forward looking incremental cost and that's what the legislation calls for, is that we pay only the costs and don't add subsidies. So we believe we are in the best position initially to win and ultimately to survive any challenges. Again the states have been supportive, in the joint board they said you should have forward looking cost. We think we are in a good position on those.

JOHN ZEGLIS: Jerry, do you think there is a snowball's chance that the RBOCs would allow a three-way merger?

A SPEAKER: I think a three-way merger is going to raise more than arithmetic possibilities of obstacles being put in front.

JOHN ZEGLIS: Last question.

A SPEAKER: Jack from Solomon. First of all, John, if you could settle with our friends at Ameritech so we could get the transcript from the conference with our friends in December.

JOHN ZEGLIS: We will be accepting service of process at lunch for any agreed analyst.

A SPEAKER: Exactly. On the access, something Jerry said or this per line trigger, a corollary thought from the discussion of maybe putting the onus of access charges, whomever collects it, on the originating as opposed to terminating end, which the theory being, I guess, you know, competitors can control the

originating end much more so. First of all, do you think that will occur?

Second of all, in your bar charts there did that include that phenomenon, and if it didn't, I would guess that for you and the other IXCs in so much as the onus has shifted toward the originating versus terminating ends, that would add above and beyond whatever you would think you would chop out of that excess.

JOHN ZEGLIS: Jack, that's hard to respond to. The bar charts were illustrative of mega movement and didn't account for shift of access from one end to the other. Our view of terminating access for the moment is when we are on the platform we are going to get as much as we receive. Whatever it is it completely washes in terms of payment out and collection in. It's almost like bill and keep. As to what do you want to know, the cost shift in the FCC moves it back on to the originating? I don't think it's going to change much of what I said. I think it's just a shift in whether we pay it on one end or the other we have to work it off by the platform.

A SPEAKER: I guess in theory you are going to go after certain customers, so in theory you will have more of a platform on the originating end, then say the random number generator on the terminating end.

JOHN ZEGLIS: It certainly makes the blue stacks I had next to the UNE customer higher and more attractive if we move it on the front end and eliminate it. Jerry, do you want to respond?

A SPEAKER: Reed Hundt and the other members of the commission have recognized the fact if you are going to use a market base approach, it depends on the market, there is greater

competition on the originating end than the terminating end. I a speech last Tuesday, Reed Hundt reiterated you would expect you would reduce access charges more on the originating end than the terminating end at the outset because that would be more responsive to what you need to do.

Th other thing is it does actually help those stacks as we get into the market while we are signing people onto the MB platform, it does help us to have terminating end access charges reduced to a certain degree.

A SPEAKER: I think you meant reduced on the terminating end.

JOHN ZEGLIS: I have to get off here. Last word to my colleagues and secondarily to the analysts, our president wants me to remind my colleagues, the 2.6 billion cost reduction does not include any advantage that we deliver up here on this settlement on the access so for you all redouble your efforts and for the analysts, you can make that additive. Thank you very much.

CONNIE WEAVER: Thank you, John. Next we are going to take a little bit of a break and go to lunch. Let me give you a couple of logistical details. We have a message center set up outside in the mid hallway as you are walking down the foyer toward the main registration area. So please check there if you have any inbound faxes or messages, they be posted there.

We also have copies of this morning's speeches. Bob Allen's speech and also John Walter's speech, if you would like to have a copy, at that same information desk. They will be available for you. We will have an informal lunch today, we will make it fairly quick, no remarks at lunch, it's an opportunity for you

to meet and get to know some of our senior team that's here today, they will be sitting amongst you. That will be over where you registered where you came in the main lobby, some tables set up in the lobby, but also in Cuisine and the Watson's restaurants there will be people to tell you where that is. I would like to reconvene at about 12:45 today, in about an hour and 15 minutes. Enjoy lunch.

Thank you.

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

IN THE

Supreme Court of the United States

OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA, *ET AL.*,
Respondents.

On Writs of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

JOINT APPENDIX
VOLUME II

MARK L. EVANS
MICHAEL K. KELLOGG
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for Petitioners BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

Counsel for Petitioners Verizon Entities

Additional Counsel Listed on Inside Cover

00-511 PETITION FOR CERTIORARI FILED SEPTEMBER 4, 2000
00-555 PETITION FOR CERTIORARI FILED SEPTEMBER 10, 2000
00-587 PETITION FOR CERTIORARI FILED SEPTEMBER 13, 2000
00-590 PETITION FOR CERTIORARI FILED SEPTEMBER 13, 2000
00-602 PETITION FOR CERTIORARI FILED SEPTEMBER 16, 2000
CERTIORARI GRANTED JANUARY 22, 2001

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING LLP
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 South Grand Avenue
Los Angeles, CA 90071
(213) 683-9100

Counsel for Petitioners
Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for Petitioner
BellSouth Corporation

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for Petitioner
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for Petitioner
United States Telecom
Association

EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.
Counsel of Record
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Petitioner WorldCom, Inc.

JONATHAN M. ASKIN
THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Petitioner The Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE TELECOMMUNICATIONS ASSOCIATION
1900 M Street, N.W.
Suite 800
Washington, D.C. 20036

ROBERT J. AAMOTH
KELLEY DRYE & WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Petitioner Competitive Telecommunications Association

JOHN E. INGLE
LAWRENCE N. BOURNE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

THEODORE B. OLSON
Solicitor General
Counsel of Record
DEPARTMENT OF JUSTICE
Washington, D.C. 20530
(202) 514-2217

Counsel for Petitioners Federal Communications Commission and the United States of America

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORPORATION
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER
Counsel of Record
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY, AUSTIN, BROWN & WOOD
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner AT&T Corporation

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent Sprint Corporation

IRWIN A. POPOWSKY
Counsel of Record
PHILLIP F. MCLELLAND
JOEL H. CHESKIS
NASUCA
c/o Pennsylvania Office of Consumer Advocate
555 Walnut Street
Forum Place, 5th Floor
Harrisburg, PA 17101
(717) 783-5048

Counsel for Respondent National Association of State Utility Consumer Advocates

LAWRENCE G. MALONE
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK
Three Empire State Plaza
Albany, NY 12223
(518) 474-2510

JAMES BRADFORD RAMSEY
Counsel of Record
SHARLA BARKLIND
NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS
1101 Vermont Ave., N.W.
#200
Washington, D.C. 20005
(202) 898-2207

Counsel for Respondents Public Service Commission of the State of New York and National Association of Regulatory Utility Commissioners

TABLE OF CONTENTS

VOLUME I

Federal Communications Commission
Relevant Docket Entries 1

United States Court of Appeals for the Eighth Circuit
Relevant Docket Entries 2

STATUTES & REGULATIONS

47 U.S.C. § 153(29) 9
47 U.S.C. § 201(b) 10
47 U.S.C. § 251 11
47 U.S.C. § 252 20
47 U.S.C. § 254 29

47 C.F.R. § 51.315 49
47 C.F.R. § 51.501 50
47 C.F.R. § 51.503 50
47 C.F.R. § 51.505 51
47 C.F.R. § 51.507 53
47 C.F.R. § 51.509 54
47 C.F.R. § 51.511 55

ADMINISTRATIVE MATERIALS

Comments of the Arizona Corporation Commission (May 16, 1996), pp. 11-12 57

Comments of AT&T Corp. (May 16, 1996), Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig 58

Comments of Bell Atlantic (May 16, 1996) Declaration of Robert W. Crandall, pp. 2, 6-10 83

Affidavit of Professor Jerry A. Hausman,
pp. 1-3, 6-8 89

Comments of the People of the State of California and the Public Utilities Commission of the State of California (May 16, 1996),
pp. 28-29 96

Comments of Connecticut Department of Public Utility Control (May 16, 1996),
Attachment C, pp. 9-10 98

Comments of GTE (May 16, 1996),
Affidavit of Edward C. Beauvais, Ph.D,
pp. 2-8. 103

Initial Comments of the Public Utilities Commission of Ohio (Phase I)(May 16, 1996),
p. 47 113

Comments of the Public Utility Commission of Texas (May 16, 1996),
¶ 45 115

Comments of the United States Telephone Association (May 16, 1996),
pp. 40-56 116

Comments of US WEST, Inc. (May 16, 1996),
Robert G. Harris and Dennis A. Yao,
Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange,
pp. 1-6 131

TABLE OF CONTENTS - Continued

Reply Comments of AT&T Corp. (May 30, 1996),
Reply Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig 140

Affidavit of Lee Selwin & Patricia Kravtin
pp. 2-3 149

Reply Comments of Bell Atlantic (May 30, 1996),
Declaration of Alfred E. Khan and Timothy J. Tardiff,
¶¶ 4-29 152

Reply Comments of Cox Communications, Inc. (May 30, 1996),
p. 27 171

Reply Comments of National Telecommunications and Information Administration (May 30, 1996),
pp. 14-34 173

Reply Comments of United States Telecom Association (May 30, 1996),
Reply Affidavit of Professor Jerry A. Hausman,
pp. 5-6, 8-11 195

Reply Comment of US WEST, Inc.(May 30, 1996),
Reply Affidavit of Robert G. Harris,
pp. 5-12 203

R. Glenn Hubbard & William H. Lehr, *Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman* (attached to Ex parte letter from Richard N. Clarke, AT&T, to William F. Caton, Secretary, FCC, CC Docket No. 96-98, July 19, 1996) 215

Kenneth C. Baseman *et al.*, *Depreciation and Capital Recovery Issues, A Response to Professor Hausman*, MICRA (July 24, 1996) (attached to Ex parte letter from Leonard Sawicki, MCI Telecommunications to William Caton, Secretary, FCC, CC Docket No. 96-98, July 24, 1996). 240

Excerpts from *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15,499 (1996).
¶¶ 1 - 15 264
¶ 29 273
¶ 86 274
¶ 123 275
¶ 176 276
¶¶ 217 - 218 277
¶¶ 258 - 270 278
¶¶ 277 - 288 287
¶¶ 292 - 297 295
¶¶ 307 - 314 299
¶ 329 306
¶¶ 332 - 333 307
¶¶ 377 - 396 308
¶ 412 323
¶¶ 618 - 740 325
¶¶ 764 - 765 424
¶¶ 790-798 425
¶ 835 433
¶¶ 859 - 862 434
¶ 875 436
¶¶ 907 - 908 437
¶ 915 438
¶ 965 439
¶ 1054 439
¶ 1056 440
¶ 1065 441
Statement of Comm'r Chong 443

MISCELLANEOUS

Supplemental Affidavit of Dennis R. Trimble, In Appendix to GTE Service Corp.'s Motion For Stay Pending Judicial Review and For Expedited Judicial Review, *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) (No. 96-3321) 453

Transcript, "AT&T Investment Community Meeting" (Mar. 3, 1997) 464

VOLUME II

In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Report & Order, 11 F.C.C.R. 15,499 (1996) 500

TABLE OF CONTENTS - Continued

NOTICE

The following document has been omitted in the printing of Volume I of this Appendix. It may be found in Appendix A to Verizon Communications Inc.'s Petition for Writ of Certiorari at the following pages:

Opinion, *Iowa Utilities Board v. FCC*,
219 F.3d 744 (8th Cir. July 18, 2000) 1a-43a

FCC 96-325

Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	)	CC Docket No. 96-98
	)	
	)	
Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers	)	CC Docket No. 95-185
	)	
	)	

FIRST REPORT AND ORDER

Adopted: August 1, 1996 Released: August 8, 1996

By the Commission: Chairman Hundt and Commissioners Quello, Ness, and Chong issuing separate statements.

Table of Contents

I. INTRODUCTION, OVERVIEW, AND EXECUTIVE SUMMARY 1
A. The Telecommunications Act of 1996 - A New Direction 1
B. The Competition Trilogy: Section 251, Universal Service Reform and Access Charge Reform 6
C. Economic Barriers 10
D. Operational Barriers 16
E. Transition 21
F. Executive Summary 24

II. SCOPE OF THE COMMISSION'S RULES 41
A. Advantages and Disadvantages of National Rules 44
B. Suggested Approaches for FCC Rules 63
C. Legal Authority of the Commission to Establish Regulations Applicable to Intrastate Aspects of Interconnection, Resale of Services, and Unbundled Network Elements 69

D. Commission's Legal Authority and the Adoption of National Pricing Rules 104
E. Authority to Take Enforcement Action 121
F. Regulations of BOC Statements of Generally Available Terms 130
G. States' Role in Fostering Local Competition Under Sections 251 and 252 133

III. DUTY TO NEGOTIATE IN GOOD FAITH 138
A. Background 138
B. Advantages and Disadvantages of National Rules 139
C. Specific Practices that May Constitute a Failure to Negotiate in Good Faith 144
D. Applicability of Section 252 to Preexisting Agreements 157

IV. INTERCONNECTION 172
A. Relationship Between Interconnection and Transport and Termination 174
B. National Interconnection Rules 177
C. Interconnection for the Transmission and Routing of Telephone Exchange Service and Exchange Access 181
D. Interexchange Service is not Telephone Exchange Service or Exchange Access 186
E. Definition of "Technically Feasible" 192
F. Technically Feasible Points of Interconnection 207
G. Just, Reasonable, and Nondiscriminatory Rates, Terms, and Conditions of Interconnection 213
H. Interconnection that is Equal in Quality 221

V. ACCESS TO UNBUNDLED NETWORK ELEMENTS 226
A. Commission Authority to Identify Unbundled Network Elements 226
B. National Requirements for Unbundled Network Elements 231
C. Network Elements 249
D. Access to Network Elements 265
E. Standards Necessary to Identify Unbundled Network Elements 271
F. Provision of a Telecommunications Service Using Unbundled Network Elements 289
G. Nondiscriminatory Access to Unbundled Network Elements and Just, Reasonable, and Nondiscriminatory Terms and Conditions for the Provision of Unbundled Network Elements 298
H. The Relationship Between Sections 251(c)(3) and 251(c)(4) 317
I. Provision of Interexchange Services through the Use of Unbundled Network Elements 342
J. Specific Unbundling Requirements 366
1. Local Loops 367

2. Switching Capability 397
3. Interoffice Transmission Facilities 428
4. Databases and Signaling Systems 452
5. Operations Support Systems 504
6. Other Network Elements 529

VI. METHODS OF OBTAININC INTERCONNECTION AND ACCESS TO UNBUNDLED NETWORK ELEMENTS 542
A. Overview 543
B. Collocation 555
1. Collocation Standards 555
a. Adoption of National Standards 555
b. Adoption of *Expanded Interconnection* Terms and Conditions for Physical and Virtual Collocation under Section 251 559
c. The Meaning of the Term "Premises" 570
d. Collocation Equipment 576
e. Allocation of Space 583
f. Leasing Transport Facilities 588
g. Co-Carrier Cross-connect 592
h. Security Arrangements 596
i. Allowing Virtual Collocation in Lieu of Physical 599
2. Legal Issues 608
a. Relationship between *Expanded Interconnection* Tariffs and Section 251 608
b. Takings Issues 613

VII. PRICING OF INTERCONNECTION AND UNBUNDLED ELEMENTS 618
A. Overview 618
B. Cost-Based Pricing Methodology 625
1. Application of the Statutory Pricing Standard 626
2. Rate Levels 630
a. Pricing Based on Economic Cost 630
(1) Background 630
(2) Comments 635
(3) Discussion 672
(a) Total Element Long Run Incremental Cost 674
(b) Cost Measures Not Included in Forward-Looking Cost Methodology 704
(c) Fifth Amendment Issues 733
3. Rate Structure Rules 741
a. General Rate Structure Rules 741
b. Additional Rate Structure Rules for Shared Facilities 753

c. Geographic/Class-of-Service Averaging 758
C. Default Proxy Ceilings and Ranges 767
1. Use of Proxies Generally 772
2. Proxies for Specific Elements 787
a. Overview 787
b. Discussion 788
(1) Loops 788
(2) Local Switching 799
(3) Other Elements 819
3. Forward-Looking Cost Model Proxies 828
D. Other Issues 837
1. Future Adjustments to Interconnection and Unbundled Element Rate Levels 837
2. Imputation 839
3. Discrimination 851

VIII. RESALE 863
A. Scope of Section 251(c)(4) 865
B. Wholesale Pricing 878
C. Conditions and Limitations 935
1. Restrictions, Generally, and Burden of Proof 936
2. Promotions and Discounts 940
3. Below-Cost and Residential Service 954
4. Cross-Class Selling 958
5. Incumbent LEC Withdrawal of Services 965
6. Provisioning 969
D. Resale Obligations of LECs Under Section 251(b)(1) 972
E. Application of Access Charges 978

IX. DUTIES IMPOSED ON "TELECOMMUNICATIONS CARRIERS" BY SECTION 251(a) 985

X. COMMERCIAL MOBILE RADIO SERVICE INTERCONNECTION 999
A. CMRS Providers and Obligations of Local Exchange Carriers Under Section 251(b) and Incumbent Local Exchange Carriers Under Section 251(c) 1001
B. Reciprocal Compensation Arrangements Under Section 251(b)(5) 1007
C. Interconnection Under Section 251(c)(2). 1009
D. Jurisdictional Authority for Regulation of LEC-CMRS Interconnection Rates 1016

XI. OBLIGATIONS IMPOSED ON LECS BY 251(b) 1027

A. Reciprocal Compensation for Transport and Termination of Telecommunications 1027
1. Statutory Language 1027
2. Definition of Transport and Termination of Telecommunications 1028
3. Pricing Methodology 1046
4. Symmetry 1069
5. Bill and Keep 1096
B. Access to Rights of Way 1119
1. Overview 1119
2. Section 224(f): Non-discriminatory access 1123
a. Background 1123
b. Comment 1124
c. Discussion 1143
(1) Generally 1143
(2) Specific Rules 1151
(3) Guidelines Governing Certain Issues 1159
(a) Capacity Expansions 1161
(b) Reservation of space by utility 1165
(c) Definition of "Utility" 1171
(d) Application of Section 224(f)(2) to Non-Electric Utilities 1175
(e) Third Party Property Owners 1178
(f) Other Matters 1182
3. Constitutional Takings 1187
4. Modifications 1193
5. Dispute Resolution 1217
6. Reverse preemption 1232
C. Imposing Additional Obligations on LECS 1241

XII. EXEMPTIONS, SUSPENSIONS AND MODIFICATIONS OF SECTION 251 REQUIREMENTS 1249
A. Background 1249
B. Need for National Rules 1252
C. Application of Section 251(f) 1255

XIII. ADVANCED TELECOMMUNICATIONS CAPABILITIES 1266

XIV. PROVISIONS OF SECTION 252 1269
A. Section 252(e)(5) 1269
B. Requirements of Section 252(i) 1296

XV. FINAL REGULATORY FLEXIBILITY ANALYSIS 1324

A.	Need for and Objectives of this Report and Order and the Rules Herein	Adopted 1325
B.	Analysis of Significant Issues Raised in Response to the IRFA	1327
	1. Treatment of Small LECs	1328
	2. Other Issues	1331
C.	Description and Estimates of the Number of Small Entities Affected by this Report and Order	1341
	1. Telephone Companies (SIC 481)	1343
	2. Cable System Operators (SIC 4841)	1358
D.	Summary Analysis of the Projected Reporting, Recordkeeping, and Other Compliance Requirements and Steps Taken to Minimize the Significant Economic Impact of this Report and Order on Small Entities and Small Incumbent LECs, Including the Significant Alternatives Considered and Rejected	1361
E.	Report to Congress	1441
XVI.	ORDERING CLAUSES	1442

APPENDIX A	List of Commenters
APPENDIX B	Final Rules
APPENDIX C	Network Diagram
APPENDIX D	State Proxy Ceilings for the Local Loop

I. INTRODUCTION, OVERVIEW, AND EXECUTIVE SUMMARY

A. The Telecommunications Act of 1996 - A New Direction

1. The Telecommunications Act of 1996[1] fundamentally changes telecommunications regulation. In the old regulatory regime government encouraged monopolies. In the new regulatory regime, we and the states remove the outdated barriers that protect monopolies from competition and affirmatively promote efficient competition using tools forged by Congress. Historically, regulation of this industry has been premised on the belief that service could be provided at the lowest cost to the maximum number of consumers through a regulated monopoly network. State and federal regulators devoted their efforts over many decades to regulating the prices and practices of these monopolies and protecting them against competitive entry. The 1996 Act adopts precisely the opposite approach. Rather than shielding telephone companies from competition, the 1996 Act requires telephone companies to open their networks to competition.

2. The 1996 Act also recasts the relationship between the FCC and state commissions responsible for regulating telecommunications services. Until now, we and our state counterparts generally have regulated the jurisdictional segments of this industry assigned to each of us by the Communications Act of 1934. The 1996 Act forges a new partnership between state and federal regulators. This arrangement is far better suited to the coming world of competition in which historical regulatory distinctions are supplanted by competitive forces. As this Order demonstrates, we have benefitted enormously from the expertise and experience that the state commissioners and their staffs have contributed to these discussions. We look forward to the continuation of that cooperative working relationship in the coming months as each of us carries out the role assigned by the 1996 Act.

3. Three principal goals established by the telephony provisions of the 1996 Act are: (1) opening the local exchange and exchange access markets to competitive entry; (2) promoting increased competition in telecommunications markets that are already open to competition, including the long distance services market; and (3) reforming our system of universal service so that universal service is preserved and advanced as the local exchange and exchange access markets move from monopoly to competition. In this rulemaking and related proceedings, we are taking the steps that will achieve the pro-competitive, deregulatory goals of the 1996 Act. The Act directs us and our state colleagues to remove not only statutory and regulatory impediments to competition, but economic and operational impediments as well. We are directed to remove these impediments to competition in all

[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, *to be codified at* 47 U.S.C. §§ 151 *et. seq.* Hereinafter, all citations to the 1996 Act will be to the 1996 Act as codified in the United States Code unless otherwise indicated.

telecommunications markets, while also preserving and advancing universal service in a manner fully consistent with competition.

4. These three goals are integrally related. Indeed, the relationship between fostering competition in local telecommunications markets and promoting greater competition in the long distance market is fundamental to the 1996 Act. Competition in local exchange and exchange access markets is desirable, not only because of the social and economic benefits competition will bring to consumers of *local* services, but also because competition eventually will eliminate the ability of an incumbent local exchange carrier to use its control of bottleneck local facilities to impede free market competition. Under section 251, incumbent local exchange carriers (LECs), including the Bell Operating Companies (BOCs), are mandated to take several steps to open their networks to competition, including providing interconnection, offering access to unbundled elements of their networks, and making their retail services available at wholesale rates so that they can be resold. Under section 271, once the BOCs have taken the necessary steps, they are allowed to offer long distance service in areas where they provide local telephone service, if we find that entry meets the specific statutory requirements and is consistent with the public interest. Thus, under the 1996 Act, the opening of one of the last monopoly bottleneck strongholds in telecommunications -- the local exchange and exchange access markets -- to competition is intended to pave the way for enhanced competition in *all* telecommunications markets, by allowing all providers to enter all markets. The opening of all telecommunications markets to all providers will blur traditional industry distinctions and bring new packages of services, lower prices and increased innovation to American consumers. The world envisioned by the 1996 Act is one in which all providers will have new competitive opportunities as well as new competitive challenges.

5. The Act also recognizes, however, that universal service cannot be maintained without reform of the current subsidy system. The current universal service system is a patchwork quilt of implicit and explicit subsidies. These subsidies are intended to promote telephone subscribership, yet they do so at the expense of deterring or distorting competition. Some policies that traditionally have been justified on universal service considerations place competitors at a disadvantage. Other universal service policies place the incumbent LECs at a competitive disadvantage. For example, LECs are required to charge interexchange carriers a Carrier Common Line charge for every minute of interstate traffic that any of their customers send or receive. This exposes LECs to competition from competitive access providers, which are not subject to this cost burden. Hence, section 254 of the Act requires the Commission, working with the states and consumer advocates through a Federal/State Joint Board, to revamp the methods by which universal service payments are collected and disbursed.[2] The present universal service system is incompatible with the statutory mandate to introduce efficient competition into local markets, because the current system distorts competition in

[2] *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Notice of Proposed Rulemaking *and Order Establishing Joint Board*, FCC 96-93 (rel. Mar. 8, 1996) (*Universal Service NPRM*).

those markets. For example, without universal service reform, facilities-based entrants would be forced to compete against monopoly providers that enjoy not only the technical, economic, and marketing advantages of incumbency, but also subsidies that are provided only to the incumbents.

B. The Competition Trilogy: Section 251, Universal Service Reform and Access Charge Reform

6. The rules that we adopt to implement the local competition provisions of the 1996 Act represent only one part of a trilogy. In this Report and Order, we adopt initial rules designed to accomplish the first of the goals outlined above -- opening the local exchange and exchange access markets to competition. The steps we take today are the initial measures that will enable the states and the Commission to begin to implement sections 251 and 252. Given the dynamic nature of telecommunications technology and markets, it will be necessary over time to review proactively and adjust these rules to ensure both that the statute's mandate of competition is effectuated and enforced, and that regulatory burdens are lifted as soon as competition eliminates the need for them. Efforts to review and revise these rules will be guided by the experience of states in their initial implementation efforts.

7. The second part of the trilogy is universal service reform. In early November, the Federal/State Universal Service Joint Board, including three members of this Commission, will make its recommendations to the Commission. These recommendations will serve as the cornerstone of universal service reform. The Commission will act on the Joint Board's recommendations and adopt universal service rules not later than May 8, 1997, and, we hope, even earlier. Our universal service reform order, consistent with section 254, will rework the subsidy system to guarantee affordable service to all Americans in an era in which competition will be the driving force in telecommunications. By reforming the collection and distribution of universal service funds, the states and the Commission will also ensure that the goals of affordable service and access to advanced services are met by means that enhance, rather than distort, competition. Universal service reform is vitally connected to the local competition rules we adopt today.

8. The third part of the trilogy is access charge reform. It is widely recognized that, because a competitive market drives prices to cost, a system of charges which includes non-cost based components is inherently unstable and unsustainable. It also well-recognized that access charge reform is intensely interrelated with the local competition rules of section 251 and the reform of universal service. We will complete access reform before or concurrently with a final order on universal service.

9. Only when all parts of the trilogy are complete will the task of adjusting the regulatory framework to fully competitive markets be finished. Only when our counterparts at the state level complete implementing and supplementing these rules will the complete

blueprint for competition be in place. Completion of the trilogy, coupled with the reduction in burdensome and inefficient regulation we have undertaken pursuant to other provisions of the 1996 Act, will unleash marketplace forces that will fuel economic growth. Until then, incumbents and new entrants must undergo a transition process toward fully competitive markets. We will, however, act quickly to complete the three essential rulemakings. We intend to issue a notice of proposed rulemaking in 1996 and to complete the access charge reform proceeding concurrently with the statutory deadline established for the section 254 rulemaking. This timetable will ensure that actions taken by the Joint Board in November and this Commission by not later than May 1997 in the universal service reform proceeding will be coordinated with the access reform docket.

C. Economic Barriers

10. As we pointed out in our Notice of Proposed Rulemaking in this docket[3], the removal of statutory and regulatory barriers to entry into the local exchange and exchange access markets, while a necessary precondition to competition, is not sufficient to ensure that competition will supplant monopolies. An incumbent LEC's existing infrastructure enables it to serve new customers at a much lower incremental cost than a facilities-based entrant that must install its own switches, trunking and loops to serve its customers.[4] Furthermore, absent interconnection between the incumbent LEC and the entrant, the customer of the entrant would be unable to complete calls to subscribers served by the incumbent LEC's network. Because an incumbent LEC currently serves virtually all subscribers in its local serving area,[5] an incumbent LEC has little economic incentive to assist new entrants in their efforts to secure a greater share of that market. An incumbent LEC also has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable conditions for terminating calls from the entrant's customers to the incumbent LEC's subscribers.

11. Congress addressed these problems in the 1996 Act by mandating that the most significant economic impediments to efficient entry into the monopolized local market must be removed. The incumbent LECs have economies of density, connectivity, and scale; traditionally, these have been viewed as creating a natural monopoly. As we pointed out in our NPRM, the local competition provisions of the Act require that these economies be shared

[3] *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Notice of Proposed Rulemaking, FCC 96-182 (rel. Apr. 19, 1996), 61 Fed. Reg. 18311 (Apr. 25, 1996) (NPRM).

[4] *See* NPRM at para. 6.

[5] *See* NPRM at n.13.

with entrants. We believe they should be shared in a way that permits the incumbent LECs to maintain operating efficiency to further fair competition, and to enable the entrants to share the economic benefits of that efficiency in the form of cost-based prices.[6] Congress also recognized that the transition to competition presents special considerations in markets served by smaller telephone companies, especially in rural areas.[7] We are mindful of these considerations, and know that they will be taken into account by state commissions as well.

12. The Act contemplates three paths of entry into the local market -- the construction of new networks, the use of unbundled elements of the incumbent's network, and resale. The 1996 Act requires us to implement rules that eliminate statutory and regulatory barriers and remove economic impediments to each. We anticipate that some new entrants will follow multiple paths of entry as market conditions and access to capital permit. Some may enter by relying at first entirely on resale of the incumbent's services and then gradually deploying their own facilities. This strategy was employed successfully by MCI and Sprint in the interexchange market during the 1970's and 1980's. Others may use a combination of entry strategies simultaneously -- whether in the same geographic market or in different ones. Some competitors may use unbundled network elements in combination with their own facilities to serve densely populated sections of an incumbent LEC's service territory, while using resold services to reach customers in less densely populated areas. Still other new entrants may pursue a single entry strategy that does not vary by geographic region or over time. Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy. Moreover, given the likelihood that entrants will combine or alter entry strategies over time, an attempt to indicate such a preference in our section 251 rules may have unintended and undesirable results. Rather, our obligation in this proceeding is to establish rules that will ensure that all pro-competitive entry strategies may be explored. As to success or failure, we look to the market, not to regulation, for the answer.

13. We note that an entrant, such as a cable company, that constructs its own network will not necessarily need the services or facilities of an incumbent LEC to enable its own subscribers to communicate with each other. A firm adopting this entry strategy, however, still will need an agreement with the incumbent LEC to enable the entrant's customers to place calls to and receive calls from the incumbent LEC's subscribers.[8] Sections 251(b)(5) and (c)(2) require incumbent LECs to enter into such agreements on just, reasonable, and nondiscriminatory terms and to transport and terminate traffic originating on another carrier's network under reciprocal compensation arrangements. In this item, we adopt rules for states

[6] *See* NPRM at paras. 10-12.

[7] 47 U.S.C. § 251(f).

[8] *See infra*, Section IV.A.

to apply in implementing these mandates of section 251 in their arbitration of interconnection disputes, as well as their review of such arbitrated arrangements, or a BOC's statement of generally available terms. We believe that our rules will assist the states in carrying out their responsibilities under the 1996 Act, thereby furthering the Act's goals of fostering prompt, efficient, competitive entry.

14. We also note that many new entrants will not have fully constructed their local networks when they begin to offer service.[9] Although they may provide some of their own facilities, these new entrants will be unable to reach all of their customers without depending on the incumbent's facilities. Hence, in addition to an arrangement for terminating traffic on the incumbent LEC's network, entrants will likely need agreements that enable them to obtain wholesale prices for services they wish to sell at retail and to use at least some portions of the incumbents' facilities, such as local loops and end office switching facilities.

15. Congress recognized that, because of the incumbent LEC's incentives and superior bargaining power, its negotiations with new entrants over the terms of such agreements would be quite different from typical commercial negotiations. As distinct from bilateral commercial negotiation, the new entrant comes to the table with little or nothing the incumbent LEC needs or wants. The statute addresses this problem by creating an arbitration proceeding in which the new entrant may assert certain rights, including that the incumbent's prices for unbundled network elements must be "just, reasonable and nondiscriminatory."[10] We adopt rules herein to implement these requirements of section 251(c)(3).

D. Operational Barriers

16. The statute also directs us to remove the existing operational barriers to entering the local market. Vigorous competition would be impeded by technical disadvantages and other handicaps that prevent a new entrant from offering services that consumers perceive to be equal in quality to the offerings of incumbent LECs. Our recently-issued number portability Report and Order addressed one of the most significant operational barriers to

[9] Joint Managers' Statement, S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 113 (1996) ("Joint Explanatory Statement") at 121.

[10] *See* 47 U.S.C.§ 251(c)(3)

competition by permitting customers to retain their phone numbers when they change local carriers.[11]

17. Closely related to number portability is dialing parity, which we address in a companion order.[12] Dialing parity enables a customer of a new entrant to dial others with the convenience an incumbent provides, regardless of which carrier the customer has chosen as the local service provider. The history of competition in the interexchange market illustrates the critical importance of dialing parity to the successful introduction of competition in telecommunications markets. Equal access enabled customers of non-AT&T providers to enjoy the same convenience of dialing "1" plus the called party's number that AT&T customers had. Prior to equal access, subscribers to interexchange carriers (IXCs) other than AT&T often were required to dial more than 20 digits to place an interstate long-distance call. Industry data show that, after equal access was deployed throughout the country, the number of customers using MCI and other long-distance carriers increased significantly.[13] Thus, we believe that equal access had a substantial pro-competitive impact. Dialing parity should have the same effect.

18. This Order addresses other operational barriers to competition, such as access to rights of way, collocation, and the expeditious provisioning of resale and unbundled elements to new entrants. The elimination of these obstacles is essential if there is to be a fair opportunity to compete in the local exchange and exchange access markets. As an example, customers can voluntarily switch from one interexchange carrier to another extremely rapidly, through automated systems. This has been a boon to competition in the interexchange market. We expect that moving customers from one local carrier to another rapidly will be essential to fair local competition.

19. As competition in the local exchange market emerges, operational issues may be among the most difficult for the parties to resolve. Thus, we recognize that, along with the state commissions and the courts, we will be called upon to enforce provisions of arbitrated agreements and our rules relating to these operational barriers to entry. Because of the critical importance of eliminating these barriers to the accomplishment of the Act's pro-competitive

[11] *Telephone Number Portability*, CC Docket No. 95-116, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-286 (rel. July 2, 1996) (*Number Portability Order*). Consistent with the 19 Act, 47 U.S.C. §251(b)(2), we required LECs to implement interim and long-term measures to ensure that customers can change their local service providers without having to change their phone number. Number portability promotes competition by making it less expensive and less disruptive for a customer to switch providers, thus freeing the customer to choose the local provider that offers the best value.

[12] NPRM paras. 202-219.

[13] Federal Communications Commission, STATISTICS OF COMMUNICATIONS COMMON CARRIERS 1994-95, at 344, Table 8.8; Federal Communications Commission, REPORT ON LONG DISTANCE MARKET SHARE, Second Quarter 1995, at 14, table 6 (Oct. 1995).

objectives, we intend to enforce our rules in a manner that is swift, sure, and effective. To this end we will review, with the states, our enforcement techniques during the fourth quarter of 1996.

20. We recognize that during the transition from monopoly to competition it is vital that we and the states vigilantly and vigorously enforce the rules that we adopt today and that will be adopted in the future to open local markets to competition. If we fail to meet that responsibility, the actions that we take today to accomplish the 1996 Act's pro-competitive, deregulatory objectives may prove to be ineffective.

E. Transition

21. We consider it vitally important to establish a "pro-competitive, deregulatory national policy framework"[14] for local telephony competition, but we are acutely mindful of existing common carrier arrangements, relationships, and expectations, particularly those that affect incumbent LECs. In light of the timing issues described above, we think it wise to provide some appropriate transitions.

22. In this regard, this Order sets minimum, uniform, national rules, but also relies heavily on states to apply these rules and to exercise their own discretion in implementing a pro-competitive regime in their local telephone markets. On those issues where the need to create a factual record distinct to a state or to balance unique local considerations is material, we ask the states to develop their own rules that are consistent with general guidance contained herein. The states will do so in rulemakings and in arbitrating interconnection arrangements. On other issues, particularly those related to pricing, we facilitate the ability of states to adopt immediate, temporary decisions by permitting the states to set proxy prices within a defined range or subject to a ceiling. We believe that some states will find these alternatives useful in light of the strict deadlines of the law. For example, section 252(b)(4)(C) requires a state commission to complete the arbitration of issues that have been referred to it, pursuant to section 252(b)(1), within nine months after the incumbent local exchange carrier received the request for negotiation. Selection of the actual prices within the range or subject to the ceiling will be for the state commission to determine. Some states may use proxies temporarily because they lack the resources necessary to review cost studies in rulemakings or arbitrations. Other states may lack adequate resources to complete such tasks before the expiration of the arbitration deadline. However, we encourage all states to complete the necessary work within the statutory deadline. Our expectation is that the bulk of interconnection arrangements will be concluded through arbitration or agreement, by the beginning of 1997. Not until then will we be able to determine more precisely the impact of this Order on promoting competition. Between now and then, we are eager to continue our work with the states. In this period, as set forth earlier, we should be able to take major steps

[14] Joint Explanatory Statement at 1.

toward implementing a new universal service system and far-reaching reform of interstate access. These reforms will reflect intensive dialogue between us and the states.

23. Similarly, as states implement the rules that we adopt in this order as well as their own decisions, they may find it useful to consult with us, either formally or informally, regarding particular aspects of these rules. We encourage and invite such inquiries because we believe that such consultations are likely to provide greater certainty to the states as they apply our rules to specific arbitration issues and possibly to reduce the burden of expensive judicial proceedings on states. A variety of formal and informal procedures exist under our rules for such consultations, and we may find it helpful to fashion others as we gain additional experience under the 1996 Act.

F. Executive Summary

1. Scope of Authority of the FCC and State Commissions

24. The Commission concludes that sections 251 and 252 address both interstate and intrastate aspects of interconnection, resale services, and access to unbundled elements. The 1996 Act moves beyond the distinction between interstate and intrastate matters that was established in the 1934 Act, and instead expands the applicability of national rules to historically intrastate issues, and state rules to historically interstate issues. In the Report and Order, the Commission concludes that the states and the FCC can craft a partnership that is built on mutual commitment to local telephone competition throughout the country, and that under this partnership, the FCC establishes uniform national rules for some issues, the states, and in some instances the FCC, administer these rules, and the states adopt additional rules that are critical to promoting local telephone competition. The rules that the FCC establishes in this Report and Order are minimum requirements upon which the states may build. The Commission also intends to review and amend the rules it adopts in this Report and Order to take into account competitive developments, states' experiences, and technological changes.

2. Duty to Negotiate in Good Faith

25. In the Report and Order, the Commission establishes some national rules regarding the duty to negotiate in good faith, but concludes that it would be futile to try to determine in advance every possible action that might be inconsistent with the duty to negotiate in good faith. The Commission also concludes that, in many instances, whether a party has negotiated in good faith will need to be decided on a case-by-case basis, in light of the particular circumstances. The Commission notes that the arbitration process set forth in section 252 provides one remedy for failing to negotiate in good faith. The Commission also concludes that agreements that were negotiated before the 1996 Act was enacted, including agreements between neighboring LECs, must be filed for review by the state commission pursuant to section 252(a). If the state commission approves such agreements, the terms of

those agreements must be made available to requesting telecommunications carriers in accordance with section 252(i).

3. Interconnection

26. Section 251(c)(2) requires incumbent LECs to provide interconnection to any requesting telecommunications carrier at any technically feasible point. The interconnection must be at least equal in quality to that provided by the incumbent LEC to itself or its affiliates, and must be provided on rates, terms, and conditions that are just, reasonable, and nondiscriminatory. The Commission concludes that the term "interconnection" under section 251(c)(2) refers only to the physical linking of two networks for the mutual exchange of traffic. The Commission identifies a minimum set of five "technically feasible" points at which incumbent LECs must provide interconnection: (1) the line side of a local switch (for example, at the main distribution frame); (2) the trunk side of a local switch; (3) the trunk interconnection points for a tandem switch; (4) central office cross-connect points; and (5) out-of-band signalling facilities, such as signalling transfer points, necessary to exchange traffic and access call-related databases. In addition, the points of access to unbundled elements (discussed below) are also technically feasible points of interconnection. The Commission finds that telecommunications carriers may request interconnection under section 251(c)(2) to provide telephone exchange or exchange access service, or both. If the request is for such purpose, the incumbent LEC must provide interconnection in accordance with section 251(c)(2) and the Commission's rules thereunder to any telecommunications carrier, including interexchange carriers and commercial mobile radio service (CMRS) providers.

4. Access to Unbundled Elements

27. Section 251(c)(3) requires incumbent LECs to provide requesting telecommunications carriers nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory. In the Report and Order, the Commission identifies a minimum set of network elements that incumbent LECs must provide under this section. States may require incumbent LECs to provide additional network elements on an unbundled basis. The minimum set of network elements the Commission identifies are: local loops, local and tandem switches (including all vertical switching features provided by such switches), interoffice transmission facilities, network interface devices, signalling and call-related database facilities, operations support systems functions, and operator and directory assistance facilities. The Commission concludes that incumbent LECs must provide nondiscriminatory access to operations support systems functions by January 1, 1997. The Commission concludes that access to such operations support systems is critical to affording new entrants a meaningful opportunity to compete with incumbent LECs. The Commission also concludes that incumbent LECs are required to provide access to network elements in a manner that allows requesting carriers to combine such elements as they choose, and that incumbent LECs

may not impose restrictions upon the uses to which requesting carriers put such network elements.

5. Methods of Obtaining Interconnection and Access to Unbundled Elements

28. Section 251(c)(6) requires incumbent LECs to provide physical collocation of equipment necessary for interconnection or access to unbundled network elements at the incumbent LEC's premises, except that the incumbent LEC may provide virtual collocation if it demonstrates to the state commission that physical collocation is not practical for technical reasons or because of space limitations. The Commission concludes that incumbent LECs are required to provide for any technically feasible method of interconnection or access requested by a telecommunications carrier, including physical collocation, virtual collocation, and interconnection at meet points. The Commission adopts, with certain modifications, some of the physical and virtual collocation requirements it adopted earlier in the *Expanded Interconnection* proceeding. The Commission also establishes rules interpreting the requirements of section 251(c)(6).

6. Pricing Methodologies

29. The 1996 Act requires the states to set prices for interconnection and unbundled elements that are cost-based, nondiscriminatory, and may include a reasonable profit. To help the states accomplish this, the Commission concludes that the state commissions should set arbitrated rates for interconnection and access to unbundled elements pursuant a forward-looking economic cost pricing methodology. The Commission concludes that the prices that new entrants pay for interconnection and unbundled elements should be based on the local telephone companies Total Service Long Run Incremental Cost of a particular network element, which the Commission calls "Total Element Long-Run Incremental Cost" (TELRIC), plus a reasonable share of forward-looking joint and common costs. States will determine, among other things, the appropriate risk-adjusted cost of capital and depreciation rates. For states that are unable to conduct a cost study and apply an economic costing methodology within the statutory time frame for arbitrating interconnection disputes, the Commission establishes default ceilings and ranges for the states to apply, on an interim basis, to interconnection arrangements. The Commission establishes a default range of 0.2-0.4 cents per minute for switching. For tandem switching, the Commission establishes a default ceiling of 0.15 cents per minute. The Order also establishes default ceilings for the other unbundled network elements.

7. Access Charges for Unbundled Switching

30. Nothing in this Report and Order alters the collection of access charges paid by an interexchange carrier under Part 69 of the Commission's rules, when the incumbent LEC provides exchange access service to an interexchange carrier, either directly or through service

resale. Because access charges are not included in the cost-based prices for unbundled network elements, and because certain portions of access charges currently support the provision of universal service, until the access charge reform and universal service proceedings have been completed, the Commission continues to provide for a certain portion of access charge recovery with respect to use of an incumbent LEC's unbundled switching element, for a defined period of time. This will minimize the possibility that the incumbent LEC will be able to "double recover," through access charges, the facility costs that new entrants have already paid to purchase unbundled elements, while preserving the status quo with respect to subsidy payments. Incumbent LECs will recover from interconnecting carriers the carrier common line charge and a charge equal to 75% of the transport interconnection charge for all interstate minutes traversing the incumbent LECs local switches for which the interconnecting carriers pay unbundled network element charges. This aspect of the Order expires at the earliest of: 1) June 30, 1997; 2) the effective date of final decisions by the Commission in the universal service and access reform proceedings; or 3) if the incumbent LEC is a Bell Operating Company (BOC), the date on which that BOC is authorized under section 271 of the Act to provide in-region interLATA service, for any given state.

31. For a similar limited period, incumbent LECs may charge the same portions of any intrastate access charges comparable to the carrier common line charge (CCLC) and the transport interconnection charge (TIC), as well as any existing explicit universal service support mechanisms based on intrastate access charges. During this period, incumbent LECs may continue to recover such revenues from purchasers of unbundled local switching elements that use those elements to originate or terminate intrastate toll calls for end user customers they win from incumbent LECs. These state mechanisms must end on the earlier of: (1) June 30, 1997; (2) the effective date of a state commission decision that an incumbent LEC may not assess such charges; and (3) if the incumbent LEC that receives the access charge revenues is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. The last end date will apply only to the recovery of charges in those states in which the BOC is authorized to offer interLATA service.

8. Resale

32. The 1996 Act requires all incumbent LECs to offer for resale any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers. Resale will be an important entry strategy both in the short term for many new entrants as they build out their own facilities and for small businesses that cannot afford to compete in the local exchange market by purchasing unbundled elements or by building their own networks. State commissions must identify marketing, billing, collection, and other costs that will be avoided or that are avoidable by incumbent LECs when they provide services wholesale, and calculate the portion of the retail rates for those services that is attributable to the avoided and avoidable costs. The Commission identifies certain avoided costs, and the application of this definition is left to the states. If a state elects not to

implement the methodology, it may elect, on an interim basis, a discount rate from within a default range of discount rates established by the Commission. The Commission establishes a default discount range of 17-25% off retail prices, leaving the states to set the specific rate within that range, in the exercise of their discretion.

9. Requesting Telecommunications Carriers

33. The Commission concludes that, to the extent that a carrier is engaged in providing for a fee local, interexchange, or international basic services directly to the public or to such classes of users as to be effectively available directly to the public, the carrier is a "telecommunications carrier," and is thus subject to the requirements of section 251(a) and the benefits of section 251(c). The Commission concludes that CMRS providers are telecommunications carriers, and that private mobile radio service (PMRS) providers generally are not telecommunications carriers, except to the extent that a PMRS provider uses excess capacity to provide local, interexchange, or international services for a fee directly to the public. The Commission also concludes that, if a company provides both telecommunications services and information services, it must be classified as a telecommunications carrier.

10. Commercial Mobile Radio Service

34. The Commission concludes that LECs are obligated, pursuant to section 251(b)(5) and the corresponding pricing standards of section 252(d)(2) to to enter into reciprocal compensation arrangements with CMRS providers, including paging providers, for the transport and termination of traffic on each other's networks. The Commission concludes that many CMRS providers (specifically cellular, broadband PCS and covered specialized mobile radio (SMR) providers) offer telephone exchange service and exchange access, and that incumbent LECs therefore must make interconnection available to these CMRS providers in conformity with sections 251(c) and 252. The Commission concludes that CMRS providers should not be classified as LECs at this time. The Commission also concludes that it may apply section 251 and 252 to LEC-CMRS interconnection. By opting to proceed under sections 251 and 252, the Commission is not finding that section 332 jurisdiction over interconnection has been repealed by implication, and the Commission acknowledges that section 332, in tandem with section 201, is a basis for jurisdiction over LEC-CMRS interconnection.

11. Transport and Termination

35. The 1996 Act requires that charges for transport and termination of traffic set based on "additional cost." The Commission concludes that state commissions, during arbitrations, should set symmetrical prices based on the local telephone company's forward-looking economic costs. The state commissions would use the TELRIC methodology when establishing rates for transport and termination. The Commission establishes a default range

of 0.2-0.4 cents per minute for end office termination for states which have not conducted a TELRIC cost study. The Commission finds significant evidence in the record in support of the lower end of the range. In addition, the Commission finds that additional reciprocal charges could apply to termination through a tandem switch. The default ceiling for tandem switching is 0.15 cents per minute, plus applicable charges for transport from the tandem switch to the end office. Each state opting for the default approach for a limited period of time, may select a rate within that range.

12. Access to Rights of Way

36. The Commission amends its rules to implement the pole attachment provisions of the 1996 Act. Specifically, the Commission establishes procedures for nondiscriminatory access by cable television systems and telecommunications carriers to poles, ducts, conduits, and rights-of-way owned by utilities or LECs. The Order includes several specific rules as well as a number of more general guidelines designed to facilitate the negotiation and mutual performance of fair, pro-competitive access agreements without the need for regulatory intervention. Additionally, an expedited dispute resolution is provided when good faith negotiations fail, as are requirements concerning modifications to poles, ducts, conduits, and rights-of-way and the allocation of the costs of such modifications.

13. Obligations Imposed on non-incumbent LECs

37. The Commission concludes that states generally may not impose on non-incumbent LECs the obligations set forth in section 251(c) entitled, "Additional Obligations on Incumbent Local Exchange Carriers." Section 251(h)(2) sets forth a process by which the Commission may decide to treat LECs as incumbent LECs, and state commissions or other interested parties may ask the Commission to issue a rule, in accordance with section 251(h)(2), providing for the treatment of a LEC as an incumbent LEC. In addition to this Report and Order, the Commission addresses in separate proceedings some of the obligations, such as dialing parity and number portability, that section 251(b) imposes on all LECs.

14. Exemptions, Suspensions, and Modifications of Section 251 Requirements

38. Section 251(f)(1) provides for exemption from the requirements in section 251(c) for rural telephone companies (as defined by the 1996 Act) under certain circumstances. Section 251(f)(2) permits LECs with fewer than 2 percent of the nation's subscriber lines to petition for suspension or modification of the requirements in sections 251(b) or (c). In the Report and Order, the Commission establishes a very limited set of rules interpreting the requirements of section 251(f). For example, the Commission finds that LECs bear the burden of proving to the state commission that a suspension or modification of the requirements of section 251(b) or (c) is justified. Rural LECs bear the burden of proving that continued exemption of the requirements of section 251(c) is justified, once a bona fide

request has been made by a carrier under section 251. The Commission also concludes that only LECs that, at the holding company level, have fewer than 2 percent of the nation's subscriber lines are entitled to petition for suspension or modification of requirements under section 251(f)(2). For the most part, however, the states will interpret the provisions of section 251(f) through rulemaking and adjudicative proceedings, and will be responsible for determining whether a LEC in a particular instance is entitled to exemption, suspension, or modification of section 251 requirements.

15. Commission Responsibilities Under Section 252

39. Section 252(e)(5) requires the Commission to assume the state's responsibilities under section 252 if the state "fails to act to carry out its responsibility" under that section. In the Report and Order, the Commission adopts a minimum set of rules that will provide notice of the standards and procedures that the Commission will use if it has to assume the responsibility of a state commission under section 252(e)(5). The Commission concludes that, if it arbitrates agreements, it will use a "final offer" arbitration method, under which each party to the arbitration proposes its best and final offer, and the arbitrator chooses among the proposals. The arbitrator could choose a proposal in its entirety, or could choose different parties' proposals on an issue-by-issue basis. In addition, the parties could continue to negotiate an agreement after they submit their proposals and before the arbitrator makes a decision.

40. Section 252(i) of the 1996 Act requires that incumbent LECs make available to any requesting telecommunications carrier any individual interconnection, service, or network element on the same terms and conditions as contained in any agreement approved under Section 252 to which they are a party. The Commission concludes that section 252(i) entitles all carriers with interconnection agreements to "most favored nation" status regardless of whether such a clause is in their agreement. Carriers may obtain any individual interconnection, service, or network element under the same terms and conditions as contained in any publicly filed interconnection agreement without having to agree to the entire agreement. Additionally, carriers seeking interconnection, network elements, or services pursuant to section 252(i) need not make such requests pursuant to the procedures for initial section 251 requests, but instead may obtain access to agreement provisions on an expedited basis.

II. SCOPE OF THE COMMISSION'S RULES

41. In implementing section 251, we conclude that some national rules are necessary to promote Congress's goals for a national policy framework and serve the public interest, and that states should have the major responsibility for prescribing the specific terms and conditions that will lead to competition in local exchange markets. Our approach in this Report and Order has been a pragmatic one, consistent with the Act, with respect to this allocation of responsibilities. We believe that the steps necessary to implement section 251 are not appropriately characterized as a choice between specific national rules on the one hand and substantial state discretion on the other. We adopt national rules where they facilitate administration of sections 251 and 252, expedite negotiations and arbitrations by narrowing the potential range of dispute where appropriate to do so, offer uniform interpretations of the law that might not otherwise emerge until after years of litigation, remedy significant imbalances in bargaining power, and establish the minimum requirements necessary to implement the nationwide competition that Congress sought to establish. This is consistent with our obligation to "complete all actions necessary to establish regulations to implement the requirements" of section 251.[15] Some of these rules will be relatively self-executing. In many instances, however, the rules we establish call on the states to exercise significant discretion and to make critical decisions through arbitrations and development of state-specific rules. Over time, we will continue to review the allocation of responsibilities, and we will reallocate them if it appears that we have inappropriately or inefficiently designated the decisionmaking roles.

42. The decisions in this Report and Order, and in this Section in particular, benefit from valuable insights provided by states based on their experiences in establishing rules and taking other actions intended to foster local competition. Through formal comments, *ex parte* meetings, and open forums,[16] state commissioners and their staffs provided extensive, detailed information to us regarding difficult or complex issues that they have encountered, and the various approaches they have adopted to address those issues. Information from the states highlighted both differences among communities within states, as well as similarities among states. Recent state rules and orders that take into account the local competition provisions of the 1996 Act have been particularly helpful to our deliberations about the types of national

[15] 47 U.S.C. § 251(d)(1).

[16] Public forum held on March 15, 1996, by FCC's Office of General Counsel to discuss interpretation of sections 251 and 252 of the Telecommunications Act of 1996; public forum held on July 9, 1996, by FCC's Common Carrier Bureau and Office of General Counsel to discuss implementation of section 271 of the Telecommunications Act of 1996.

rules that will best further the statute's goal of encouraging local telephone competition.[17] These state decisions also offered useful insights in determining the extent to which the Commission should set forth uniform national rules, and the extent to which we should ensure that states can impose varying requirements. Our contact with state commissioners and their staffs, as well as recent state actions, make clear that states and the FCC share a common commitment to creating opportunities for efficient new entry into the local telephone market. Our experience in working with state commissions since passage of the 1996 Act confirms that we will achieve that goal most effectively and quickly by working cooperatively with one another now and in the future as the country's emerging competition policy presents new difficulties and opportunities.

43. We also received helpful advice and assistance from other government agencies, including the National Telecommunications and Information Administration (NTIA), the Department of Justice, and the Department of Defense about how national rules could further the public interest. In addition, comments from industry members and consumer advocacy groups helped us understand better the varying and competing concerns of consumers and different representatives of the telecommunications industry. We benefitted as well by discovering that there are certain matters on which there is substantial agreement about the role the Commission should play in establishing and enforcing provisions of section 251.

A. Advantages and Disadvantages of National Rules

1. Background

44. Section 251(d)(1) instructs the Commission, within six months after the enactment of the 1996 Act (that is, by August 8, 1996), to "establish regulations to implement the requirements of [section 251]."[18] In addition, section 253 requires the Commission to preempt the enforcement of any state or local statute, regulation, or legal requirement that "prohibit[s]

[17] *See, e.g.*, Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms and Condition and the Initial Unbundling of Services, Docket No. 6352-U (Georgia Commission May 29, 1996); AT&T Communications of Illinois, Inc. *et al.*, Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company, Nos. 95-0458 and 95-0531 (consol.) (Illinois Commission June 26, 1996); Hawaii Administrative Rules, Ch. 6-80, "Competition in Telecommunications Services," (Hawaii Commission May 17, 1996); Public Utilities Commission of Ohio Case No. 95-845-TP-COI (Local Competition) (Ohio Commission June 12, 1996) and Implementation of the Mediation and Arbitration Provisions of the Federal Telecommunications Act of 1996, Case No. 96-463-TP-UNC (Ohio Commission May 30, 1996); Proposed Rules regarding Implementation of §§ 40-15-101 *et seq.* Requirements relating to Interconnection and Unbundling, Docket No. 95R-556T (Colorado Commission April 25, 1996) (one of a series of Orders adopted by the Colorado Commission in response to the local competition provisions of the 1996 Act); Washington Utilities and Transportation Commission, Fifteenth Supplemental Order, Decision and Order Rejecting Tariff Revisions, Requiring Refiling, Docket No. UT-950200 (Washington Commission April 1996).

[18] 47 U.S.C. § 251(d)(1). The Commission's implementing rules should be designed "to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition." Joint Explanatory Statement at 1.

or [has] the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service."[19]

45. In the NPRM, we stated our belief that we should implement Congress's goal of a pro-competitive, de-regulatory, national policy framework by adopting national rules that are designed to secure the full benefits of competition for consumers, with due regard to work already done by the states.[20] We sought comment on the extent to which we should adopt explicit national rules, and the extent to which permitting variations among states would further Congress's pro-competitive goals.[21] We anticipated that we would rely on actions some states have already taken to address interconnection and other issues related to opening local markets to competition. In the NPRM, we set forth some of the benefits that would likely result from implementing explicit national rules, and some of the benefits that would likely result from allowing variations among states.[22]

2. Comments

46. The parties recommend a broad spectrum of approaches with respect to the scope and detail of Commission regulations. The vast majority of potential local competitors, such as interexchange carriers (IXCs), competitive access providers (CAPs), and cable operators, assert that the Commission should adopt clear and explicit national standards that will serve as the backdrop for negotiations and will establish minimum requirements for arbitrated agreements.[23] Other parties, including federal agencies, consumer groups, and equipment manufacturers, also support explicit national rules.[24] These parties contend that explicit national standards are useful, or even critical, to achieving the pro-competitive goals enunciated by Congress.

[19] 47 U.S.C. § 253(a) and (d).

[20] NPRM at para. 26 (*citing* Joint Explanatory Statement at 1).

[21] NPRM at paras. 27, 35.

[22] NPRM at paras. 30-33.

[23] *See, e.g.*, AT&T comments at 3; MCI comments at 4-6; Sprint comments at 4-6; MFS comments at 5-6; Jones Intercable comments at 11, 13; Cable & Wireless comments at 6-7; LCI comments at 2, 13; TCC comments at 5-6; Hyperion comments at 6; Ad Hoc Telecommunications Users Committee comments at 3-10; LDDS reply at 4.

[24] *See, e.g.*, SBA comments at 4; Ohio Consumers' Counsel comments at 2-3; DoJ comments at 5-8; Lucent comments at 3; Frontier reply at 7; IDCMA reply at 2-9; NTIA reply at 3; National Association of the Deaf reply at 1-3; Texas Public Utility Counsel reply at 2.

47. Parties supporting explicit national rules assert that national standards will give incumbent LECs an incentive to negotiate if the national rules would subject the incumbents to less advantageous terms than they otherwise would be likely to negotiate.[25] Other advantages of national standards, according to these parties, include: reducing the likelihood of potentially inconsistent determinations by state commissions and courts,[26] and reducing burdens on new entrants that seek to provide service on a regional or national basis by limiting their need for separate network configurations and marketing strategies, and by increasing predictability.[27] As a result, they assert, new entrants would have greater access to capital necessary to develop competing services.[28] Parties state that collectively, these advantages demonstrate that national standards will foster competition more quickly than regulations developed on a state-by-state basis.[29] In addition, some parties contend that clear national standards also will assist both the states in arbitrating and reviewing agreements within the time frames set forth in section 252 and the FCC in arbitrating agreements under section 252(e)(5) where states have failed to act, and in reviewing BOC applications to enter

[25] *See, e.g.*, AT&T comments at 6-8 (noting that this is particularly true for non-BOC incumbent LECs, such as SNET and GTE, which already have interLATA authority and have no reason to comply with section 251); Cable & Wireless comments at 7-9; Hyperion comments at 7; MFS comments at 5-6; Teleport comments at 14-17 (vague standards will allow incumbents to adopt a "take it or leave it" approach); TCC comments at 5-7; Comcast reply at 5; CompTel reply at 7; LDDS reply at 3-4; NTIA reply at 3; PageNet reply at 4; *see also* Citizens Utilities comments at 5 (FCC should establish minimum standards sufficient to equalize bargaining power between incumbents and new entrants); Cox comments at 10; Excel comments at 2-3. *But see, e.g.*, Ameritech comments at 7-9 (incumbent LECs do not have vastly superior bargaining power, and cannot unilaterally impose terms upon other parties); PacTel comments at 6; USTA comments at 6 n.9 (the NPRM overstates the bargaining power of incumbent LECs; in particular, non-BOC LECs may have less bargaining power than IXCs, cable companies, or competitive access providers); USTA reply at 2-4; Bell Atlantic reply at 3.

[26] ALTS comments at 2-4; ACSI comments at 4; AT&T comments at 9-10; Cox comments at 22-23; DoJ comments at 12; Frontier comments at 6; GSA/DoD comments at 4-5; TIA comments at 5; MCI comments at 4-6 (differing rules will make it difficult to develop a rational national policy); TCC comments at 7-8, 13 (federal rules will eliminate the need for new entrants to expend resources fighting the same battle in 50 states); *accord* Cable & Wireless comments at 10 (even 50 excellent plans are not optimal if they are 50 different plans).

[27] AT&T comments at 9; Cable & Wireless comments at 6-9 (cost efficiencies of national networks are substantial); Excel comments at 2; Hyperion comments at 5; GST comments at 2; Jones Intercable comments at 11; Ohio Consumers' Counsel comments at 3; SBA comments at 4 (national rules will particularly help small competitors); Sprint comments at 3; TCC comments at 7-8; ACSI reply at 4; *see also* Intermedia comments at 3 (national uniform standards are necessary to resolve the many regulatory, technical and operational questions that accompany interconnection to incumbent LEC networks); Lucent comments at 3 (national standards will promote industry growth and assist telecommunications equipment vendors); SDN Users Association comments at 2; International Communications Ass'n comments at 3.

[28] ALTS comments at 2-4; GSA/DoD comments at 4-5; MCI comments at 4-6. *But see* GTE reply at 6 (uniform federal rules will not affect the ability of large, financially well-positioned entities like AT&T to obtain capital).

[29] *See, e.g.*, ALTS comments at 2-4; Competition Policy Institute comments at 10; DoJ comments at 13-15 (a single set of rules can be created faster than 50 different sets).

in-region interLATA markets pursuant to section 271.[30] Some parties that favor strong national rules caution against prematurely dismantling consumer protection rules and relying instead on competitive market conditions that do not yet exist.[31] Many commercial mobile radio service (CMRS) providers contend that national rules governing LEC-CMRS interconnection are necessary to foster development of a ubiquitous, nationwide network.[32]

48. Some state regulatory commissions advocate explicit national standards, at least in some areas. For example, the Massachusetts Commission states that the FCC can and should establish national rules in implementing section 251, except in the area of pricing.[33] The Kentucky Commission asserts that uniform national rules for market entry are necessary to ensure successful local competition, and that national pricing principles will aid states in setting rates during the arbitration process and in reviewing BOC statements of generally available terms.[34] The North Dakota Commission asserts that, while some states may not need federal support, specific standards would provide a necessary and significant benefit for North Dakota, in light of its limited resources to implement a pro-competitive regulatory regime.[35] The Illinois Commission states that minimum national rules are a major step toward competitive markets, but that states should be permitted to implement and enforce additional rules.[36]

[30] Ad Hoc Telecommunications Users Committee comments at 9-10; AT&T comments at 8-9, 11; Cable & Wireless comments at 7-9; CompTel comments at 22; Excel comments at 2.

[31] *See, e.g.*, Competition Policy Institute reply at 2, 11.

[32] *See, e.g.*, Vanguard comments in CC Docket No. 95-185 at 26; Centennial comments in CC Docket No. 95-185 at 31.

[33] Mass. Commission comments at 4-5. What, if any, rules the Commission should, as both a legal and policy matter, adopt with respect to pricing is addressed separately in *infra*, Section II.D.

[34] Kentucky Commission comments at 3-4. Section 252(f) permits a BOC to file for review by a state commission a statement of terms and conditions that the BOC offers to comply with the regulations of section 251 and the regulations thereunder. A BOC may be permitted to provide in-region interLATA service if, ten months after enactment of the 1996 Act, no carrier has requested access and interconnection (as described in section 271(c)(1)(A)) and the BOC has a statement of generally available terms and conditions that a state commission has approved or permitted to take effect. *See also* Kansas Commission comments at 4-5 (national interconnection standards to enable inter-company provisioning and national performance standards will facilitate negotiations and reduce the incumbent's negotiating advantage).

[35] North Dakota Commission comments at 1-2; *see also* Illinois Commission comments at 9-10 (minimum federal standards will give direction to states, will help create consistency among states, and will serve as a major step in the transition toward a competitive market, but states should be able to augment and build upon national standards).

[36] Illinois Commission comments at 9-10.

49. Some parties contend that national rules are particularly important for small competitors' entry into local markets.[37] Barriers to market entry, which cause delay, raise transactional costs, or otherwise impose economically inefficient constraints, are particularly threatening to small competitors, according to the Small Business Administration. Moreover, the Small Business Administration contends that the needs of small competitors deserve special consideration, because they are likely to fill niche market needs that larger competitors typically overlook.[38]

50. Other commenters oppose explicit national rules, or seek significant limits on the scope and detail of FCC requirements. The majority of state commissions and incumbent LECs advocate that the Commission establish general, broad regulations or guidelines, and leave substantial opportunity for the parties to negotiate specific terms,[39] with the states to establish specific requirements if the parties cannot reach agreement.[40] BellSouth urges the Commission merely to codify the language of the 1996 Act.[41]

51. Parties that oppose explicit national standards assert that they are contrary to the Act,[42] could impede the development of local competition,[43] and will undermine progressive

[37] *See, e.g.*, SBA comments at 3-4.

[38] *Id; accord, e.g.*, Richard N. Koch comments at 1-2; ATSI reply at 7-8. *Contra, e.g.*, Colorado Ind. Tel. Ass'n comments at 2-3; GVNW comments at 2; NARUC comments at 8; Joint Consumer Advocates reply at 5-6 (national standards will be particularly burdensome for small or rural LECs, and will make it difficult for "niche" providers to succeed); Rural Tel. Coalition comments at 4-8.

[39] Ameritech comments at 6; Bell Atlantic comments at 2-3; Georgia Commission comments at 3-5; Illinois Commission comments at 13; Lincoln Tel. comments at 3-4; Rural Tel. Coalition comments at 2; South Carolina Commission comments at 2-3; SBC comments at 4-5, 19-21; TDS comments at 3 (Congress evinced a preference for voluntarily negotiated agreements and the FCC should not try to alter the Act's mechanisms for transitioning to competition); USTA comments at 6; Ohio Consumers' Counsel reply at 3.

[40] *See, e.g.*, USTA comments at 6-8; Alabama Commission comments at 10; Ameritech comments at 4, 6; Bell Atlantic comments at 1-2; Iowa Commission comments at 2, 4; NARUC comments at 4, 22-24; Idaho Commission comments at 2-4; North Carolina Commission Staff comments at 10-11; Oklahoma Commission comments at 1-3; Puerto Rico Tel. comments at 3-4; *accord* Alliance for Public Technology comments at 8-10; CFA/CU comments at 4-5; Rural Tel. Coalition comments at 2, 6; TDS comments at 3; Texas Commission comments at 4-5.

[41] BellSouth comments at 3-5.

[42] Alaska Tel. Ass'n comments at 2; Ameritech comments at 9; Bell Atlantic comments at 2-3; GTE comments at 12-14; Puerto Rico Tel. comments at 2-3; Rural Tel. Coalition comments at 2, 6; SBC comments at 8-10, 18-19.

actions already taken by states.[44] They also assert that states should be given the opportunity to experiment with different approaches intended to promote local competition,[45] and that technical, economic, geographic, and demographic variations require tailored responses by state commissions.[46] For example, GTE states that, "[i]n reality, each local market is different -- some are flat, others are hilly or mountainous; some are densely populated, others are suburban or rural; some have state-of-the-art technology, others retain older facilities; some possess a temperate climate, others suffer harsh storms; some are wealthy, others are poor; some have a high proportion of business customers, others are predominantly residential."[47] Many parties counter that geographic differences do not merit state-specific rules instead of national rules.[48] They contend that the differences cited by GTE exist among different locales, but that many states include most of these variations within their borders.[49]

52. State commissions and incumbent LECs reject the suggestion that the FCC is required to impose nationally uniform requirements in order to achieve Congress's goals. For example, in support of its claim that Congress did not intend national uniformity, the New

[43] Ad Hoc Coalition of Corporate Telecommunications Managers comments at 2; BellSouth comments at 3-5; District of Columbia Commission comments at 11•12; Georgia Commission comments at 2; Maryland Commission comments at 2-3; Oregon Commission comments at 7, 25; PacTel comments at 1-3; California Commission reply at 8; *see also* Illinois Commission comments at 9-10 (overly extensive federal regulation could inhibit competition by restricting a state's ability to respond to technological and market developments and regional differences).

[44] Connecticut Commission comments at 8-9; GTE comments at 10; Maryland Commission comments at 5-6, 12; MECA comments at 11-12; Municipal Utilities comments at 6-8; North Carolina Commission Staff comments at 9-10; Oregon Commission comments at iv, 7; PacTel comments at 1-3; Washington Commission comments at 1-2.

[45] *See, e.g.*, Alliance for Public Technology comments at 8-10; Florida Commission comments at 2-3, 6; New York Commission comments at 18-19; Pennsylvania Commission comments at 17; TDS comments at 11.

[46] *See, e.g.*, District of Columbia Commission comments at 7; North Carolina Commission comments at 2-8; Wyoming Commission comments at 4-5 (Wyoming is rural and sparsely populated, and has among the highest costs in the country, but residents in both cities and rural areas require access to sophisticated services; it cannot "afford to be subjected needlessly to the problems which models designed to address other people's problems would cause").

[47] GTE comments at 7-8.

[48] ALTS comments at 4 (aside from universal service issues that are being addressed by a Joint Board in a separate proceeding, there are no unique policy concerns that states need to address or that would be endangered by national rules); Cable & Wireless comments at 9; DoJ comments at 13-15; GCI comments at 4; MCI comments at 4-6 (networks are not designed on a state-specific basis); Jones Intercable comments at 12; Cox reply at 4 n.8.

[49] *See, e.g.*, AT&T comments at 12.

York Commission cites the fact that agreements may be negotiated without reference to the Commission's regulations under section 251(b) and (c), and that under section 251(d)(3), states may impose rules consistent with the Act.[50]

3. Discussion

53. Comments and *ex parte* discussions with state commission representatives have convinced us that we share with states a common goal of promoting competition in local exchange markets. We conclude that states and the FCC can craft a working relationship that is built on mutual commitment to local service competition throughout the country, in which the FCC establishes uniform, national rules for some issues, the states and the FCC administer these rules, and the states adopt other critically important rules to promote competition. In implementing the national rules we adopt in this Report and Order, states will help to illuminate and develop innovative solutions regarding many complex issues for which we have not attempted to prescribe national rules at this time, and states will adopt specific rules that take into account local concerns. In this Report and Order, and in subsequent actions we intend to take, we have and will continue to seek guidance from various states that have taken the lead in establishing pro-competitive requirements.[51] Virtually every decision in this Report and Order borrows from decisions reached at the state level, and we expect this close association with and reliance on the states to continue in the future. We therefore encourage states to continue to pursue their own pro-competitive policies. Indeed, we hope and expect that this Report and Order will foster an interactive process by which a number of policies consistent with the 1996 Act are generated by states.

54. We find that certain national rules are consistent with the terms and the goals of the statute. Section 251 sets forth a number of rights with respect to interconnection, resale services, and unbundled network elements. We conclude that the Commission should define at least certain minimum obligations that section 251 requires, respectively, of all telecommunications carriers, LECs, or incumbent LECs. For example, as discussed in more detail below, we conclude that it is reasonable to identify a minimum number of network elements that incumbent LECs must unbundle and make available to requesting carriers pursuant to the standards set forth in sections 251(c) and (d), while also permitting states to go beyond that minimum list and impose additional requirements that are consistent with the 1996 Act and the FCC's implementing rules. We find no basis for permitting an incumbent LEC in some states not to make available these minimum technically feasible network elements that are provided by incumbent LECs in other states. We point out, however, that a

[50] New York Commission comments at 12-13; *see also* Maryland Commission comments at 9, 13, 20; Washington Commission comments at 7-8 (referencing section 252(e)(3)); Rural Tel. Coalition reply at 6.

[51] We also expect to rely heavily on state input and experience in other FCC proceedings, such as access reform and petitions concerning BOC entry into in-region interLATA markets.

uniform rule does not necessarily mean uniform results. For example, a national pricing methodology takes into account local factors and inputs, and thus may lead to different prices in different states, and different regions within states. In addition, parties that voluntarily negotiate agreements need not comply with the requirements we establish under sections 251(b) and (c), including any pricing rules we adopt.[52] We intend to review on an ongoing basis the rules we adopt herein in light of competitive developments, states' experiences, and technological changes.

55. We find that incumbent LECs have no economic incentive, independent of the incentives set forth in sections 271 and 274 of the 1996 Act, to provide potential competitors with opportunities to interconnect with and make use of the incumbent LEC's network and services. Negotiations between incumbent LECs and new entrants are not analogous to traditional commercial negotiations in which each party owns or controls something the other party desires. Under section 251, monopoly providers are required to make available their facilities and services to requesting carriers that intend to compete directly with the incumbent LEC for its customers and its control of the local market. Therefore, although the 1996 Act requires incumbent LECs, for example, to provide interconnection and access to unbundled elements on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, incumbent LECs have strong incentives to resist such obligations. The inequality of bargaining power between incumbents and new entrants militates in favor of rules that have the effect of equalizing bargaining power in part because many new entrants seek to enter national or regional markets. National (as opposed to state) rules more directly address these competitive circumstances.

56. We emphasize that, under the statute, parties may voluntarily negotiate agreements "without regard to" the rules that we establish under sections 251(b) and (c).[53] However, fair negotiations will be expedited by the promulgation of national rules. Similarly, state arbitration of interconnection agreements now and in the future will be expedited and simplified by a clear statement of terms that must be included in every arbitrated agreement, absent mutual consent to different terms. Such efficiency and predictability should facilitate entry decisions, and in turn enhance opportunities for local exchange competition. In addition, for new entrants seeking to provide service on a national or regional basis, minimum national requirements may reduce the need for designing costly multiple network configurations and marketing strategies, and allow more efficient competition. More efficient competition will, in turn, benefit consumers. Further, national rules will reduce the need for competitors to revisit the same issue in 51 different jurisdictions, thereby reducing administrative burdens and litigation for new entrants and incumbents.

[52] 47 U.S.C. § 252(a)(1).

[53] 47 U.S.C. § 252(a)(1).

57. We also believe that some explicit national standards will be helpful in enabling the Commission and the states to carry out other responsibilities under the 1996 Act. For example, national standards will enable the Commission to address issues swiftly if the Commission is obligated to assume section 252 responsibilities because a state commission has failed to act.[54] In addition, BOCs that seek to offer long distance service in their service areas must satisfy, *inter alia*, a "competitive checklist" set forth in section 271(c)(2)(B). Many of the competitive checklist provisions require compliance with specific provisions of section 251. For example, the checklist requires BOCs to provide "nondiscriminatory access to network elements in accordance with the requirements of sections 251(c)(3) and 252(d)(1)."[55] Some national rules also will help the states, the DOJ, and the FCC carry out their responsibilities under section 271, and assist BOCs in determining what steps must be taken to meet the requirements of section 271(c)(2)(B), the competitive checklist. In addition, national rules that establish the minimum requirements of section 251 will provide states with a consistent standard against which to conduct the fact-intensive process of verifying checklist compliance, the DOJ will have standards against which to evaluate the applications, and we will have standards to apply in adjudicating section 271 petitions in an extremely compressed time frame. Moreover, we believe that establishing minimum requirements that arbitrated agreements must satisfy will assist states in arbitrating and reviewing agreements under section 252, particularly in light of the relatively short time frames for such state action. While some states reject the idea that national rules will help the state commissions to satisfy their obligations under section 252 to mediate, arbitrate, and review agreements, other states have welcomed national rules, at least with respect to certain matters.[56]

58. A broad range of parties urge the Commission to adopt minimum requirements that would permit states to impose additional, pro-competitive requirements that are consistent with the 1996 Act to address local or state-specific circumstances. We agree generally that many of the rules we adopt should establish non-exhaustive requirements, and that states may impose additional pro-competitive requirements that are consistent with the purposes and

[54] *See* 47 U.S.C. § 252(e)(5).

[55] 47 U.S.C. § 271(c)(2)(B)(ii).

[56] For example, the Georgia and Colorado Commissions support national technical standards for interconnection and collocation, although they generally disfavor detailed standards. Georgia Commission comments at 2; Colorado Commission comments at 2-4. The Illinois Commission, which has aggressively sought to open opportunities for local telephone competition, asserts that minimum national rules are important in developing competitive local telephone service, although it urges the Commission to permit states to implement and enforce additional rules that are consistent with the national rules. Illinois Commission comments at 9-10. The North Dakota Commission has expressed a need for specific national guidance to enable the commission to carry out its obligations under the Act. North Dakota Commission comments at 1-2.

terms of the 1996 Act, including our regulations established pursuant to section 251.[57] We also anticipate that the rules we adopt regarding interconnection, services, and access to unbundled elements will evolve to accommodate developments in technology and competitive circumstances, and that we will continue to draw on state experience in applying our rules and in addressing new or additional issues. We recognize that it is vital that we reexamine our rules over time in order to reflect developments in the dynamic telecommunications industry. We cannot anticipate all of the changes that will occur as a result of technological advancements, competitive developments, and practical experience, particularly at the state level. Therefore, ongoing review of our rules is inevitable. Moreover, we conclude that arbitrated agreements must permit parties to incorporate changes to our national rules, or to applicable state rules as such changes may be effective, without abrogating the entire contract. This will ensure that parties, regardless of when they enter into arbitrated agreements, will be able to take advantage of all applicable Commission and state rules as they evolve.

59. Some parties contend that even minimum requirements may impede the ability of state commissions to take varying approaches to address particular circumstances or conditions. We agree with the contention that, although there are different market conditions from one area to another, such distinct areas do not necessarily replicate state boundaries.[58] For example, virtually all states include both more densely-populated areas and sparsely populated rural areas, and all include both business and residential areas. Although each state is unique in many respects, demographic and other differences among states do not suggest that national rules are inappropriate. Moreover, even though it may not be appropriate to impose identical requirements on carriers with different network technologies, our rules are intended to accommodate such differences.[59] Some parties have argued that explicit national standards will delay the emergence of local telephone competition, but none has offered persuasive evidence to substantiate that claim, and new entrants overwhelmingly favor strong national rules. We conclude, for the reasons set forth above, that some national rules will enhance opportunities for local competition, and we have chosen to adopt national rules where necessary to establish the minimum requirements for a nationwide pro-competitive policy framework.

---

[57] In contrast, we conclude that the 1996 Act limits the obligations states may impose on non-incumbent carriers. *See infra*, Section XI.C.

[58] AT&T comments at 12.

[59] *See infra*, Section IV.E. (concluding that successful interconnection or access to an unbundled element at a particular point in the network creates a rebuttable presumption that such interconnection or access is technically feasible at networks that employ *substantially similar facilities*). We agree with parties, such as the Ohio Consumers' Counsel, that physical networks are not designed on a state-by-state basis. Ohio Consumers' Counsel comments at 4.

60. We disagree with those parties that claim we are trying to impose a uniformity that Congress did not intend. Variations among interconnection agreements will exist, because parties may negotiate their own terms, states may impose additional requirements that differ from state to state, and some terms are beyond the scope of this Report and Order. We conclude, however, that establishing certain rights that are available, through arbitration, to all requesting carriers, will help advise parties of their minimum rights and obligations, and will help speed the negotiation process. In effect, the Commission's rules will provide a national baseline for terms and conditions for all arbitrated agreements. Our rules also may tend to serve as a useful guide for negotiations by setting forth minimum requirements that will apply to parties if they are unable to reach agreement. This is consistent with the broad delegation of authority that Congress gave the Commission to implement the requirements set forth in section 251.

61. We also believe that national rules will assist smaller carriers that seek to provide competitive local service. As noted above, national rules will greatly reduce the need for small carriers to expend their limited resources securing their right to interconnection, services, and network elements to which they are entitled under the 1996 Act. This is particularly true with respect to discrete geographic markets that include areas in more than one state.[60] We agree with the Small Business Administration that national rules will reduce delay and lower transaction costs, which impose particular hardships for small entities that are likely to have less of a financial cushion than larger entities.[61] In addition, even a small provider may wish to enter more than one market, and national rules will create economies of scale for entry into multiple markets. We reject the position advocated by some parties that we should not adopt national rules because such rules will be particularly burdensome for small or rural incumbent LECs.[62] We note, however, that section 251(f) provides relief from some of our rules.

62. We recognize the concern of many state commissions that the Commission not undermine or reverse existing state efforts to foster local competition. We believe that Congress did not intend for us needlessly to disrupt the pro-competitive actions some states already have taken that are both consistent with the 1996 Act and our rules implementing section 251.[63] We believe our rules will in many cases be consistent with pro-competitive

---

[60] Approximately 17 Personal Communications Service (PCS) providers have Basic Service Areas/Metropolitan Statistical Areas, for example, that cross state lines.

[61] SBA comments at 3-4.

[62] *See, e.g.*, Joint Consumer Advocates reply at 5-6.

[63] 47 U.S.C. § 251(d)(3).

actions already taken by states, and in fact, many of the rules we adopt are based directly on existing state commission actions. We also intend to continue to reflect states' experiences as we revise our rules. We also recognize, however, that in at least some instances existing state requirements will not be consistent with the statute and our implementing rules.[64] It will be necessary in those instances for the subject states to amend their rules and alter their decisions to conform to our rules. In our judgment, national rules are highly desirable to achieve Congress's goal of a pro-competitive national policy framework for the telecommunications industry.

B. Suggested Approaches for FCC Rules

1. Comments

63. Parties propose a variety of approaches that the Commission could take in establishing rules for interconnection, network unbundling, and other issues addressed in section 251.[65] Many parties suggest that the Commission can, and should, establish regulations within six months of the date of enactment of the 1996 Act, and continue on an ongoing basis to revise and amend rules regarding interconnection, service, and access to unbundled network elements.[66] Parties have differing views about why Congress imposed relatively short time frames for action by states and the FCC.[67] Some parties suggest that the Commission take a largely "hands off" approach initially, but that it set more specific rules if and when such rules are needed.[68] IXCs, state commissions, incumbent LECs and others

[64] *See infra*, Section II.C.

[65] *See, e.g.*, Cox comments at 22-23; Illinois Commission comments at 9-10; MCI comments at 12; MFS comments at 5-6; SBA comments at 5; Attorneys General reply at 3; California Commission reply at 10-11; Minnesota Ind. Coalition reply at 3-4; National Association of the Deaf reply at 1-3.

[66] MCI reply at 5; Sprint reply at 11.

[67] *See, e.g.*, DoJ comments at 13-15 (the short time frame in which to establish rules evidences Congress's desire to bring about change quickly, which could only occur through a single set of rules, rather than through many iterations); *contra, e.g.*, SBC comments at 10 (the short time frames for seeking arbitration and for state commission review of agreements reflect Congress's desire to bring about change more quickly than the pace that the regulatory process historically has achieved).

[68] Alliance for Public Technology comments at 8-10; U S West comments at 3-4, Illinois Commission comments at 9-10.

agree that, in setting national rules, the Commission should learn from and build upon the experiences of the states.[69]

64. Some state commissions and incumbent LECs recommend that the FCC establish general, broad principles rather than detailed requirements.[70] Several parties favor a "preferred outcomes" approach similar to the one adopted in California.[71] Under that approach, the FCC would establish acceptable or "preferred" outcomes, but parties would have the opportunity to justify deviation from those outcomes.[72] The California Commission argues that we should establish a range of guidelines that are detailed enough to be easy to implement by states that have not yet developed rules for competition, but flexible enough to allow states to continue their pro-competitive efforts without disruption.[73] At least one party, however, asserts that a "preferred outcomes" approach is not sufficient to provide incumbent LECs with an incentive to bargain in good faith.[74]

65. Some state commissions recommend that, if the FCC does establish explicit requirements, states should be allowed to impose different requirements. For example, the Illinois Commission urges the FCC to adopt a process by which states may seek a waiver from the national regulations, upon a showing of need.[75] The Ohio and Florida Commissions recommend that the FCC adopt explicit requirements that states could choose to adopt, but that states would have the option of developing their own requirements.[76] Under the proposal recommended by the Ohio Commission, existing state regulations that are consistent with the

[69] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 11-13; MCI comments at 12; Sprint comments at 6-7.

[70] Citizens Utilities comments at 3; Guam Telephone Authority comments at 5; Lincoln Tel. comments at 1, 3; District of Columbia Commission comments at 11-12.

[71] *See, e.g.*, GTE comments at 12-14; PacTel comments at 1-3; Washington Commission comments at 1-2; ALTS comments at 2-4; Teleport comments at 14-17; Texas Public Utility Counsel reply at 2; Minnesota Ind. Coalition reply at 8.

[72] ALTS comments at 2-4.

[73] California Commission reply at 4-7.

[74] Comcast reply at 5.

[75] Illinois Commission comments at 13; *accord* AT&T comments at 11; ACTA comments at 2-4.

[76] Florida Commission comments at 2-3; Ohio Commission comments at 4-5; *accord* NYNEX reply at 4.

1996 Act would be "grandfathered."[77] In addition, if a state failed to adopt any rules regarding competitive entry into local markets within a specified time, the FCC rules would be binding.[78]

2. Discussion

66. We intend to adopt minimum requirements in this proceeding; states may impose additional pro-competitive requirements that are consistent with the Act and our rules. We decline to adopt a "preferred outcomes" approach, because such an approach would fail to establish explicit national standards for arbitration, and would fail to provide sufficient guidance to the parties' options in negotiations. To the extent that parties advocate "preferred outcomes" from which the parties could deviate in arbitrated agreements, we reject such a proposal, because we conclude that it would not provide the benefits conferred by establishing "default" requirements. To the extent that commenters advocate a regulatory approach that would require parties to justify a negotiated result different from the preferred outcomes, we believe that such an approach would impose greater constraints on voluntarily negotiated agreements than the 1996 Act permits. Under the 1996 Act, parties may freely negotiate any terms without justifing deviation from "preferred outcomes."[79] The only restriction on such negotiated agreements is that they must be deemed by the state commission to be nondiscriminatory and consistent with the public interest, under the standards set forth in section 252(e)(2)(A). In response to the Illinois Commission's suggestion that we adopt a process by which states may seek waivers of our rules, we note that Commission rules already provide for waiver of our rules under certain circumstances.[80] We decline to adopt a special waiver process in this proceeding.

67. We intend our rules to give guidance to the parties regarding their rights and obligations under section 251. The specificity of our rules varies with respect to different issues; in some cases, we identify broad principles and leave to the states the determination of what specific requirements are necessary to satisfy those principles. In other cases, we find that local telephone competition will be better served by establishing specific requirements. In each of the sections below, we discuss the basis for adopting particular national principles or rules.

---

[77] Ohio Commission comments at 4-5; *accord* NARUC comments at 6-7.

[78] Ohio Commission comments at 4-5.

[79] 47 U.S.C. § 252(a) (parties may negotiate and enter into a binding agreement without regard to standards set forth in sections 251(b) and (c)).

[80] 47 C.F.R. § 1.3.

68. We also believe that we should periodically review and amend our rules to take into account experiences of carriers and states, technological changes, and market developments. The actions we take here are fully responsive to Congress's mandate that we complete all actions necessary to establish regulations to implement the requirements of section 251 by August 8, 1996.[81] We nevertheless retain authority to refine or augment our rules, or to follow a different course, after developing some practical experience with the rules adopted herein. It is beyond doubt that the Commission has ongoing rulemaking authority. For example, section 4(i) provides that the Commission "may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with the Act, as may be necessary in the execution of its functions."[82] Section 4(j) provides that the Commission "may conduct its proceedings in such manner as will best conduce to the proper dispatch and to the ends of justice."[83] We agree with Sprint, the Illinois Commission, and other parties that we should address in this rulemaking the most important issues, and continue to refine our rules on an ongoing basis to address additional or unanticipated issues, and especially to learn from the decisions and experiences of the states.[84] We also reject the argument of Margaretville Telephone Company that the 1996 Act constitutes an unconstitutional taking because it seeks to deprive incumbent LECs of their "reasonable, investment-backed expectation to hold competitive advantages over new market entrants."[85]

C. Legal Authority of the Commission to Establish Rules Applicable to Intrastate Aspects of Interconnection, Services, and Unbundled Network Elements

1. Background

69. In the NPRM, we tentatively concluded that Congress intended sections 251 and 252 to apply, and that our rules should apply, to both interstate and intrastate aspects of

---

[81] 47 U.S.C. § 251(d)(1).

[82] 47 U.S.C. § 154(i).

[83] 47 U.S.C. § 154(j). Section 11 of the 1996 Act also directs the Commission to review and modify its rules on an ongoing basis. 47 U.S.C. § 161.

[84] Sprint comments at vi, 6-7; Illinois Commission comments at 9-10. Although various parties have encouraged us to address issues that are beyond those identified in the NPRM, we will address only those topics identified in the NPRM, or that are a clear and logical outgrowth from issues specifically identified in the NPRM. *See, e.g.*, Unicom comments at 1-2 (urging the Commission to extend to IXCs the rules it adopts for LECs regarding collocation, interconnection, and unbundling); TCI comments at 15-17 (asking Commission to clarify the extent to which municipalities have control over rights-of-way under section 253).

[85] Margaretville Tel. comments at 1-4.

interconnection, services, and access to network elements.[86] We stated in the NPRM that it would seem to make little sense, in terms of economics or technology, to distinguish between interstate and intrastate components for purposes of sections 251 and 252.[87] We also believed that such a distinction would appear to be inconsistent with Congress's desire to establish a national policy framework for interconnection and other issues critical to achieving local competition. We sought comment on these tentative conclusions.

70. We further tentatively concluded in the NPRM that section 2(b) of the 1934 Act does not require a contrary conclusion.[88] Section 2(b) states that, except as provided in certain enumerated sections not including sections 251 and 252, "nothing in [the 1934] Act shall be construed to apply or to give to the Commission jurisdiction with respect to . . . charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any carrier . . . ."[89] We noted in the NPRM that sections 251 and 252 do not alter the jurisdictional division of authority with respect to matters falling outside the scope of these provisions.[90] For example, rates charged to end users for local exchange service have traditionally been subject to state authority, and will continue to be.

2. Comments

71. The parties disagree about the extent to which the FCC has authority to establish regulations pursuant to sections 251 and 252. A majority of commenters that address the issue contend that sections 251 and 252 apply to both interstate and intrastate aspects of interconnection, services, and access to unbundled network elements.[91] Other commenters contend, however, that sections 251 and 252 apply only to intrastate aspects of

[86] NPRM at para. 37.

[87] NPRM at para. 37.

[88] NPRM at para. 39.

[89] 47 U.S.C. § 152(b).

[90] NPRM at para. 40.

[91] *See, e.g.*, ACTA comments at 4; ALTS comments at 6; ACSI comments at 5; Arch comments at 5; Bell Atlantic comments at 7-8 (section 251 addresses matters of a "predominantly intrastate nature"); BellSouth comments at 8; Cable & Wireless comments at 11; CompTel comments at 15; Florida Commission comments at 7; GCI comments at 4; GSA/DoD comments at 6; GTE comments at 3; Jones Intercable comments at 10; MCI comments at 7-8; Sprint comments at 7; TCI comments at 12; Texas Commission comments at 5; NTIA reply at 6 n.15; NCTA reply at 2-7.

interconnection, services, and access to unbundled network elements.[92] None of the commenters appears to claim that section 251 addresses exclusively interstate matters. As discussed below, many parties, including BOCs and state commissions, contend that the FCC's role under sections 251 and 252 is quite limited.[93]

72. The IXCs and other potential competitors in local exchange markets generally assert that the 1996 Act expressly authorizes, and even obligates, the Commission to establish regulations regarding interstate and intrastate aspects of interconnection, service, and access to unbundled network elements. For example, MCI contends that, "[b]ecause the technical feasibility and cost of providing a particular arrangement do not depend on whether the requesting carrier uses that arrangement to provide interstate or intrastate services," it would make no sense to interpret section 251 to include a jurisdictional distinction between interstate and intrastate aspects of interconnection that does not appear on the face of that provision.[94] Several parties assert that sections 251 and 252 alter traditional jurisdictional boundaries by giving states some authority over interstate matters that they previously did not have, and by giving the FCC some new authority over intrastate matters.[95] Other parties assert that section 251 clearly applies to intrastate aspects of interconnection, services, and access to unbundled elements, and that, as a basic principle of administrative law, to the extent that section 251 addresses intrastate matters, the FCC has authority to adopt implementing regulations.[96]

73. Parties point to other provisions in the 1996 Act to show that the traditional jurisdictional division of authority between states and the FCC does not apply with respect to sections 251 and 252. MCI contends that section 253, by addressing federal preemption of both interstate and intrastate barriers to competition, makes it clear that the jurisdictional division of responsibility is inapplicable.[97] Parties also point to the fact that the Commission must in some circumstances assume the state commission's responsibilities as evidence of a

[92] NARUC comments at 9-10; New York Commission comments at 10-11; U S West comments at 10-11.

[93] Bell Atlantic comments at 7-8; GTE comments at 3; PacTel comments at 11.

[94] MCI comments at 7, 8 (it is highly unlikely that interconnection arrangements will be used exclusively for jurisdictional-specific traffic).

[95] Illinois Commission comments at 3-5, 15; Sprint comments at 5; CompTel reply at 5; Rural Tel. Coalition reply at 3.

[96] MCI reply at 36-37; Vanguard reply at 4 (*citing Time Warner v. FCC*, 56 F.3d 151, 174-76 (D.C. Cir. 1995) for the proposition that agencies are empowered to interpret their organic statutes, through rules and other mechanisms, to govern the behavior of parties regulated under those statutes).

[97] MCI comments at 7-8; *accord* Sprint comments at 4; CompTel comments at 15; TCI reply at 6.

shift in jurisdictional authority.[98] Jones Intercable asserts that sections 251 and 252 of the 1996 Act make distinctions among classes of entities (telecommunications carriers, LECs, and incumbent LECs), rather than between interstate and intrastate service.[99]

74. AT&T contends that, by requiring the Commission to "complete all actions necessary to establish regulations to implement the requirements of this Section," section 251(d)(1) requires the Commission to establish minimum national standards for interconnection, unbundling, pricing, resale, and related requirements.[100] AT&T states that the 1996 Act was created pursuant to the settled rule that federal agency regulations preempt any inconsistent state policies unless the underlying federal statute otherwise provides.[101] It interprets section 251(d)(3) to mean that any Commission regulation that reasonably implements section 251 bars state enforcement of any inconsistent state regulations, without regard to whether the preemptive provisions of section 253 would also apply. According to AT&T, the only limitation on the Commission's preemptive powers is that it may not preclude the enforcement of state access and interconnection requirements that are consistent with the 1996 Act and the FCC's implementing regulations.[102] AT&T maintains that this interpretation is consistent with the fact that section 252(c)(1) requires state commissions to ensure that nonvoluntary agreements are consistent with the Commission's regulations under section 251(d).[103]

75. AT&T further contends that section 2(b) of the Act does not limit the Commission's authority to promulgate rules under section 251, because section 251 "gives the FCC explicit authority to prescribe and enforce preemptive rules that are necessary to achieve

[98] *See, e.g.*, ACTA comments at 4; New Jersey Cable Ass'n, *et al.* reply at 18-19; TCI reply at 6.

[99] Jones Intercable comments at 10; *see also* Time Warner comments at 7; Cable & Wireless comments at 11-12 (sections 251 and 252 apply to *all* telecommunications services, and the definitions of "telecommunications," "telecommunications service," and "telecommunications carrier" are defined without reference to jurisdictional boundaries); New Jersey Cable Ass'n, *et al.* reply at 18-19; GSA/DoD reply at 7 (Congress did not intend to expand traditional interstate and intrastate jurisdictional distinctions); Competitive Policy Institute reply at 10.

[100] AT&T comments at 4 (*quoting* § 251(d)(1) of the Act).

[101] AT&T comments at 4-5 (*citing Fidelity Federal Savings and Loan Assoc. v. de la Cuesta*, 458 U.S. 141, 152-154 (1982); *City of New York v. FCC*, 467 U.S. 57, 64 (1988); *Oklahoma Natural Gas v. FERC*, 28 F.3d 1281, 1283 (D.C. Cir. 1994)).

[102] AT&T comments at 5 and nn.3-4; *accord* Cable & Wireless comments at 11 (in section 253, Congress made clear that the Commission has authority to preempt any state requirement that creates a barrier to either interstate or intrastate services, or that is inconsistent with the 1996 Act); MCI comments at 7-8; Sprint comments at 4.

[103] AT&T comments at 5-6.

the Act's purpose of developing local services competition."[104] Sprint, Comcast, and other parties assert that Congress intended section 251 to give the Commission authority over both interstate and intrastate aspects of interconnection, notwithstanding the fact that it left section 2(b) unamended.[105] For example, Comcast contends that section 253(a) authorizes the Commission to preempt any state or local requirement that prohibits or has the effect of prohibiting any interstate or intrastate telecommunications service.[106] In view of the explicit grants of authority in sections 251 and 253, Comcast asserts that it was unnecessary to amend section 2(b). Cable & Wireless contends that the fact that section 251(d)(1) provides that the FCC "shall" in some cases preempt state regulations is evidence that Congress did not believe it was required to amend section 2(b) before delegating intrastate authority to the FCC.[107] AT&T asserts that the fact that prior versions of the legislation amended section 2(b) to except Part II of Title II of the Act is not dispositive; when the language was taken out, it was not listed as a substantive change, but treated as a "minor drafting" or "clerical" change.[108] AT&T asserts that this was an appropriate characterization, because section 2(b) would not have had any effect in any event.

76. Several parties contend that the Act makes clear that states are required to apply FCC rules established under section 251. For example, sections 252(c)(1) and (f)(2) explicitly require the states to apply the FCC's regulations.[109] In addition, section 261(c) provides that state requirements must be "not inconsistent" with Part II of Title II, including the Commission's regulations thereunder.[110] Thus, the parties contend that these provisions constitute express federal preemption, and that section 601(c), which provides that any

[104] AT&T comments at 6 (section 2(b) cannot be read to nullify section 2(a) and sections 201 to 205) (*citing California v. FCC*, 39 F.3d 919, 931-33 (9th Cir. 1994); *PUC of Texas v. FCC*, 886 F.2d 1325 (D.C. Cir. 1990); *NARUC v. FCC*, 746 F.2d 1492 (D.C. Cir. 1984); *Louisiana PSC v. FCC*, 476 U.S. 355, 375-76 n.4 (1986)).

[105] Sprint comments at 7; Comcast reply at 2-3; NCTA reply at 5-6.

[106] Comcast reply at 2-3.

[107] Cable & Wireless reply at 9-10.

[108] AT&T reply at 4 n.5 (citing Joint Explanatory Statement at 113).

[109] AT&T reply at 2.

[110] Jones Intercable comments at 11-12; MCI reply at 7; MFS reply at 7; New Jersey Cable Ass'n, *et al.* reply at 23.

preemptive effect of the new law must be express, does not establish limits to the FCC's authority to establish regulations under section 251.[111]

77. Sprint states that other provisions of the 1996 Act:

> subordinate state actions and policies with respect to intrastate service to those of the Commission, *e.g.*, sections 253 (entry barriers), 254(f) (universal service), 258 (PIC change procedures), and 276 (payphone services). If Congress had intended the jurisdictional split in section 2(b) to remain unaffected by the 1996 Act, all of these very specific subordinations of state policy to federal policy would be nullities, and much of the 1996 Act would make no sense at all.[112]

Sprint contends that the only way to give meaning to both section 2(b) and the above-referenced provisions is to conclude that the section 2(b) distinctions remain in effect for "retail" services offered to end users, but that the detailed scheme for intercarrier relationships set forth in Part II of Title II supersedes section 2(b).[113] MCI concurs, and adds that this interpretation is consistent with settled principles of statutory construction that the specific prevails over the general, and the later-enacted provision prevails over the earlier-enacted provision.[114]

78. Some state commissions and some other commenters assert that section 251, as well as other provisions of the 1996 Act, support the interpretation that Congress intended states to have a primary role in setting requirements for intrastate interconnection. For example, these parties assert that section 251(d)(3) is evidence that Congress intended to permit states to implement their own access and interconnection regulations, and that this statutory language requires the FCC to fashion its regulations to avoid precluding state interconnection policy or rules.[115] They note that section 251(d)(3) requires consistency with

[111] New Jersey Cable Ass'n, *et al.* reply at 23; Jones Intercable reply at 15.

[112] Sprint comments at 7.

[113] Sprint comments at 7-8.

[114] MCI comments at 8 (*citing Stendor Enterprises Ltd. v. Armtex, Inc.*, 947 F.2d 727,732 (4th Cir. 1991); *Redhouse v. C.I.R.*, 728 F.2d 1249, 1253 (9th Cir. 1984); *Mesa Petroleum Co. v. FERC*, 688 F.2d 1014, 1016 (5th Cir. 1982)).

[115] Maryland Commission comments at 22; Ohio Commission comments at 16-17 (*citing* Joint Explanatory Statement at 1, 119); *accord, e.g.*, Bogue, Kansas comments at 4; Connecticut Commission comments at 7; NARUC comments at 14; PacTel comments at 14; Pennsylvania Commission comments at 7-9.

the Act, but does not mandate consistency with the FCC's regulations.[116] SNET asserts that, if Congress intended to preclude state discretion to interpret section 251 requirements, it would have preempted all state policies addressing those requirements, rather than just policies that substantially prevent implementation of the statute.[117] Some parties also point out that section 251(d)(3) is entitled "Preservation of state access regulations," and argue that the stated purpose of that provision is to preserve or "grandfather" most, if not all, state access and interconnection regulations.[118] They also allege that section 601(c) of the 1996 Act demonstrates that Congress intended to preserve states' authority over intrastate matters, and that any preemption finding would have to be based on an express provision.[119] Bogue, Kansas states that section 256(c) also makes clear that nothing in that section expands or limits the Commission's authority prior to the enactment of the 1996 Act.[120] The Oregon Commission argues that section 261 also permits states to impose requirements, as long as those requirements are not inconsistent with the 1996 Act.[121]

79. Some state commissions and incumbent LECs contend that the Commission's authority to establish regulations that may preempt state requirements is limited to those instances where section 251 expressly provides for Commission action.[122] Some parties also contend that, because section 252(e)(5) specifically requires the FCC to assume the responsibilities of the state commission if the state commission fails to act under section 252, the FCC's role under section 252 is limited to that specific delegation of authority.[123]

[116] Maryland Commission comments at 22; Washington Commission comments at 6-7.

[117] SNET reply at 1-2; *accord* Colorado Commission comments at 5-9.

[118] Ohio Commission reply at 3; BellSouth reply at 5.

[119] *See, e.g.*, District of Columbia Commission comments at 6; Maryland Commission comments at 21; NARUC comments at 13; Ohio Commission comments at 15-16; Wyoming Commission comments at 10; BellSouth reply at 5-6.

[120] Bogue, Kansas comments at 5.

[121] Oregon Commission comments at 13-14; *accord* Washington Commission comments at 9; Rural Tel. Coalition reply at 4.

[122] Rural Tel. Coalition comments at 5 ("Commission authority should be limited to establishing number portability requirements, regulations for limitations on resale, minimum unbundling requirements, rules for administering the North American Numbering Plan, enforcing existing access and interconnection requirements, and determining whether to treat additional carriers as incumbent LECs); *see also* District of Columbia Commission comments at 8-10; NARUC comments at 14-15; New York Commission comments at 2-3, 8.

[123] *See, e.g.*, NARUC comments at 15; New York Commission comments at 9; PacTel comments at 13.

80. These parties also reject the claim that section 251 takes precedence over section 2(b).[124] They note that section 2(b) was not amended by the 1996 Act, although prior version of the bills would have done so.[125] Moreover, parties claim that, in other instances, Congress did specifically amend section 2(b) to give the Commission authority over intrastate aspects of specified matters.[126] Bell Atlantic asserts that the failure to amend section 2(b) is "fatal to the notice's proposed federalization of intrastate interconnection and other intrastate matters."[127] The Ohio Commission expressly rejects the suggestion in the NPRM that there was no need to amend section 2(b) because sections 251 and 252 do not affect end user rates.[128]

81. Some parties further contend that preemption must be express, not implied, and that no such express statement was made in section 251.[129] Parties also assert that, by comparison, the Act is "quite clear in preempting states where it intended to do so."[130] For example, the New York Commission asserts that, in certain circumstances, section 254(f) expressly directs states to act in a manner that is "not inconsistent" with FCC rules.[131] NARUC asserts that there is a "well established presumption against finding preemption of State law in areas traditionally regulated by the States" that weighs against an interpretation

[124] *See, e.g.*, Bell Atlantic comments at 4; Connecticut Commission comments at 5; Oregon Commission comments at 12; Indiana Commission Staff comments at 4-5; Iowa Commission comments at 6.

[125] *See, e.g.*, Maryland Commission comments at 16 (*citing* Conf. Rep. No. 104-230 at 78 and H.R. 1555 Rep. No. 104-204 at 53); *accord* NARUC comments at 10 (*citing Russello v. U.S.*, 464 U.S. 16 (1989)); Oregon Commission comments at 15.

[126] California Commission comments at 11; Connecticut Commission comments at 7 (*citing* the Omnibus Budget Reconciliation Act of 1993 as an example of congressional intent to alter jurisdictional authority); Maryland Commission comments at 20; Ohio Commission comments at 14-15; BellSouth reply at 4.

[127] Bell Atlantic comments at 7.

[128] Ohio Commission comments at 15 (the 1993 amendments to section 2(b) expressly reserved to states responsibility for wholesale rates in general).

[129] *See, e.g.*, NARUC comments at 12 (*citing Hillsborough County v. Automated Medical Laboratories*, 471 U.S. 707, 175 (1985)); Arizona Commission comments at 16; Bogue, Kansas comments at 3 (*citing Gregory v. Ashcroft*, 501 U.S. 452, 460 (1991)); New York Commission comments at 6 (*citing Washington Market v. Hoffman*, 101 U.S. 112 (1879)); Municipal Utilities reply at 5 (FCC may not preempt state regulations that are consistent with the Act).

[130] Bogue, Kansas comments at 4 n.3 (section 251(e) gives FCC "exclusive jurisdiction" over some aspects of Number Administration); Maryland Commission comments at 15; Ohio Commission comments at 12, 16.

[131] New York Commission comments at 8; *see also* NARUC comments at 12 (contrasting section 276, which explicitly provides that Commission regulations shall preempt inconsistent state requirements).

that the FCC has broad regulatory authority to establish rules governing local exchange markets.[132]

82. To support their claim that, in 1934, Congress established a dual regulatory system, and that the FCC's jurisdiction is limited to interstate issues, except where otherwise expressly provided, these parties cite to the Supreme Court's decision in *Louisiana Public Service Comm'n v. FCC*.[133] The Maryland Commission contends that *Louisiana PSC* is controlling here, because: (1) the dual regulatory system was not eliminated by the 1996 Act; (2) the FCC may not rely upon the broad congressional intent to promote competition as a delegation of authority over intrastate issues; and (3) the 1996 Act does not embody a federal regulatory scheme that is so pervasive as to infer that Congress left no room for states to supplement it.[134] PacTel claims that, because section 251 was created after the decision in *Louisiana PSC*, Congress was aware that, if it wanted section 251 to override section 2(b), it would have to do so in an unambiguous manner. Consequentially, because Congress did not amend section 2(b) or otherwise expressly limit its effect, section 2(b) takes precedence over section 251 to the extent the provisions conflict.[135] Several parties offer additional bases for finding that the *Louisiana PSC* decision controls the scope of the Commission's authority under section 251.[136]

3. Discussion

[132] NARUC comments at 12 (*quoting California v. ARC America Corp.*, 490 U.S. 91, 101 (1989)).

[133] 476 U.S. 335 (1986) (*Louisiana PSC*). In that case, the Supreme Court held that section 220 of the 1934 Act, which directs the FCC to set depreciation regulations, did not give the FCC authority to preempt inconsistent state depreciation regulations for intrastate ratemaking purposes.

[134] Maryland Commission comments at 17-18 (*citing Fidelity Savings and Loan Assn v. de la Cuesta*, 458 U.S. 141, 153 (1982)); *accord* Ohio Commission comments at 11; Oregon Commission comments at 13; Washington Commission comments at 9-10.

[135] PacTel comments at 14-15.

[136] The Maryland Commission further asserts that compliance with both federal and state regulation as envisioned by the 1996 Act is not a physical impossibility that would support a claim of implied preemption. Maryland Commission comments at 18 (*citing Florida Lime & Avocado Growers Inc. v. Paul*, 373 U.S. 132, 142-43 (1963)); *accord* Washington Commission comments at 10. The Ohio Commission avers that it is possible for the FCC to promulgate rules that apply to interstate services only. Ohio Commission comments at 13. Several states also reject the idea that section 251 squarely addresses, and therefore controls, the jurisdictional issue, because there is "no mention of intrastate services or preemption of states' authority over such matters in Section 251." Ohio Commission comments at 12; Maryland Commission comments at 23; *accord* Bell Atlantic comments at 6. Pacific Telesis asserts that sections 251 and 2(b) may be read as internally consistent, and that, under rules of statutory construction, they must be so interpreted. PacTel comments at 12-13 (*citing Washington Market Co v. Hoffman*, 101 U.S. 112 (1879)). Bell Atlantic states that the Supreme Court held in *Louisiana PSC* that the rule of statutory construction that the specific takes precedence over the general does not apply where two provisions "address 'different subject[s]' and therefore 'are not general or specific with respect to each other.'" Bell Atlantic comments at 6 (*quoting Louisiana PSC*, 476 U.S. at 376 n.5); GTE reply at 5.

83. We conclude that, in enacting sections 251, 252, and 253, Congress created a regulatory system that differs significantly from the dual regulatory system it established in the 1934 Act.[137] That Act generally gave jurisdiction over interstate matters to the FCC and over intrastate matters to the states. The 1996 Act alters this framework, and expands the applicability of both national rules to historically intrastate issues, and state rules to historically interstate issues.[138] Indeed, many provisions of the 1996 Act are designed to open telecommunications markets to all potential service providers, without distinction between interstate and intrastate services.

84. For the reasons set forth below, we hold that section 251 authorizes the FCC to establish regulations regarding both interstate and intrastate aspects of interconnection, services, and access to unbundled elements. We also hold that the regulations the Commission establishes pursuant to section 251 are binding upon states and carriers and section 2(b) does not limit the Commission's authority to establish regulations governing intrastate matters pursuant to section 251. Similarly, we find that the states' authority pursuant to section 252 also extends to both interstate and intrastate matters. Although we recognize that these sections do not contain an explicit grant of intrastate authority to the Commission or of interstate authority to the states, we nonetheless find that this interpretation is the only reasonable way to reconcile the various provisions of sections 251 and 252, and the statute as a whole. As we indicated in the NPRM, it would make little sense in terms of economics or technology to distinguish between interstate and intrastate components for purposes of sections 251 and 252.[139]

85. We view sections 251 and 252 as creating parallel jurisdiction for the FCC and the states. These sections require the FCC to establish implementing rules to govern interconnection, resale of services, access to unbundled network elements, and other matters, and direct the states to follow the Act and those rules in arbitrating and approving arbitrated agreements under sections 251 and 252. Among other things, the fact that the Commission is

[137] According to Senator Pressler, "Progress is being stymied by a morass of regulatory barriers which balkanize the telecommunications industry into protective enclaves. We need to design a *national policy framework* -- a new regulatory paradigm for telecommunications -- which accommodates and accelerates technological change and innovation." 141 Cong. Rec. S7881-2, S7886 (June 7, 1995) (emphasis added). According to Representative Fields, "[Congress] is decompartmentalizing segments of the telecommunications industry, opening the floodgates of competition through deregulation, and most importantly, giving consumers choice . . .", 142 Cong. Rec. H1149 (Feb. 1, 1996).

[138] For example, section 253(a) suggests that states may establish regulations regarding interstate as well as intrastate matters.

[139] We believe that this interpretation is the most reasonable one in light of our expectation that marketing and product offerings by telecommunications carriers will diminish or eliminate the significance of interstate-intrastate distinctions.

required to assume the state commission's responsibilities if the state commission fails to carry out its section 252 responsibilities[140] gives rise to the inevitable inference that both the states and the FCC are to address the same matters through their parallel jurisdiction over both interstate and intrastate matters under sections 251 and 252.

86. The only other possible interpretations would be that: (1) sections 251 and 252 address only interstate aspects of interconnection, services, and access to unbundled elements; (2) the provisions address only the intrastate aspects of those issues; or (3) the FCC's role is to establish rules for interstate aspects, and the states' role is to arbitrate and approve agreements on intrastate aspects. As explained below, none of these interpretations withstands examination. Accordingly, we conclude that sections 251 and 252 address both interstate and intrastate aspects of interconnection services and access to unbundled elements.

87. Some parties have argued that our authority under section 251 is limited by section 2(b). Ordinarily, in light of section 2(b), we would interpret a provision of the Communications Act as addressing only the interstate jurisdiction unless the provision (as well as section 2(b) itself) provided otherwise. That interpretation is contradicted in this case, however, by strong evidence in the statute that the local competition provisions of the 1996 Act are directed to both intrastate and interstate matters. For example, section 251(c)(2), the interconnection requirement, requires LECs to provide interconnection "for the transmission and routing of *telephone exchange service* and exchange access."[141] Because telephone exchange service is a local, intrastate service, section 251(c)(2) plainly addresses intrastate service, but it also addresses interstate exchange access. In addition, we note that in section 253," the statute explicitly authorizes the Commission to preempt intrastate and interstate barriers to entry.[142]

88. More generally, if these sections are read to address only interstate services, the grant of substantial responsibilities to the states under section 252 is incongruous. A statute designed to develop a *national* policy framework to promote local competition cannot reasonably be read to reduce significantly the FCC's traditional jurisdiction over interstate matters by delegating enforcement responsibilities to the states, unless Congress intended also

[140] *See* 47 U.S.C. § 252(e)(5).

[141] 47 U.S.C. § 251(c)(2).

[142] 47 U.S.C. § 253(a).

to implement its national policies by enhancing our authority to encompass rulemaking authority over intrastate interconnection matters.[143]

89. Some parties argue that section 251 addresses solely intrastate matters. We do not find this argument persuasive.[144] Under this narrow view, section 251(c)(6) requiring incumbent LECs to offer physical collocation would apply only to equipment used for intrastate services, while new entrants would be limited to the use of virtual collocation for equipment used in the provision of interstate services, pursuant to the decision in *Bell Atlantic*.[145] Such an interpretation would force new entrants to use different methods of collocation based on the jurisdictional nature of the traffic involved, and would thereby greatly increase new entrants' costs. Moreover, such an interpretation would fail to give effect to Congress's intent in enacting section 251(c)(6) to reverse the result reached in *Bell Atlantic*.[146]

90. Another factor that makes clear that sections 251 and 252 did not address exclusively intrastate matters is the provision in section 251(g), "Continued Enforcement of Exchange Access and Interconnection Requirements." That section provides that BOCs must follow the Commission's "equal access and nondiscriminatory interconnection restrictions (including receipt of compensation)" until they are explicitly superseded by Commission regulations after the date of enactment of the 1996 Act. This provision refers to existing Commission rules governing interstate matters, and therefore it contradicts the argument that section 251 addresses intrastate matters exclusively.

91. Nor does the savings clause of section 251(i) require us to conclude that sections 251 and 252 address only intrastate issues. Section 251(i) provides that "[n]othing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201." This subsection merely affirms that the Commission's preexisting authority

[143] The legislative history is replete with statements indicating that Congress meant to address intrastate local exchange competition. For instance, Senator Lott stated that "[i]n addressing *local and long distance issues*, creating an open access and sound interconnection policy was the key objective . . ." 141 Cong. Rec. S7906 (June 7, 1995) (emphasis added). Representative Markey noted that "we take down the barriers of *local and long distance* and cable company, satellite, computer software entry into any business they want to get in." 142 Cong. Rec. H1151 (Feb. 1, 1996) (emphasis added).

[144] *See, e.g.*, New York Commission comments at 5-8.

[145] *Bell Atlantic Telephone Companies v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994) (*Bell Atlantic*) (holding that the Commission did not have authority to require physical collocation for the provision of interstate services).

[146] The language in the House bill which closely matches the language that appears in section 251(c)(6), noted that a provision requiring physical collocation was necessary "because a recent court decision indicates that the Commission lacks authority under the Communications Act to order physical collocation." H.R. Rep. No. 204, pt. I, 104th Cong., 1st Sess., at 73 (1995).

under section 201 continues to apply for purely interstate activities. It does not act as a limitation on the agency's authority under section 251.

92. As to the third possible interpretation, the FCC's role is to establish rules for only the interstate aspects of interconnection, and the states' role is to arbitrate and approve only the intrastate aspects of interconnection agreements. No commenters support this position, and we find that it would be inconsistent with the 1996 Act to read into sections 251 and 252 such a distinction. The statute explicitly contemplates that the states are to comply with the Commission's rules, and the Commission is required to assume the state commission's responsibilities if the state commission fails to act to carry out its section 252 responsibilities.[147] Thus, we believe the only logical conclusion is that the Commission and the states have parallel jurisdiction. We conclude, therefore, that these sections can only logically be read to address both interstate and intrastate aspects of interconnection, services, and access to unbundled network elements, and thus to grant the Commission authority to establish regulations under 251, binding on both carriers and states, for both interstate and intrastate aspects.

93. Section 2(b) of the Act does not require a different conclusion. Section 2(b) provides that, except as provided in certain enumerated sections not including sections 251 and 252, "nothing in [the 1934] Act shall be construed to apply or to give to the Commission jurisdiction with respect to . . . charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any carrier . . .".[148] As stated above, however, we have found that sections 251 and 252 do apply to "charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service."[149] In enacting sections 251 and 252 after section 2(b), and squarely addressing therein the issue of interstate and intrastate jurisdiction, we find that Congress intended for sections 251 and 252 to take precedence over any contrary implications based on section 2(b).[150] We note also, that in enacting the 1996 Act, there are other instances where Congress indisputably gave the Commission intrastate jurisdiction without amending section 2(b). For instance, section 251(e)(1) provides that "[t]he Commission shall

[147] 47 U.S.C. § 252(e)(5).

[148] 47 U.S.C. § 152(b).

[149] 47 U.S.C. § 152(b).

[150] *See, e.g., Morales v. Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992) ("it as a commonplace of statutory construction that the specific governs the general"); *see also* 2 J. Sutherland, Statutory Construction § 22.34 (6th ed.) (where amended and original sections of a statute cannot be harmonized, the new provisions should prevail as the latest declaration of legislative will); *American Airlines, Inc. v. Remis Industries, Inc.*, 494 F.2d 196, 200 (2nd Cir. 1974).

have exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States."[151] Section 253 directs the FCC to preempt state regulations that prohibit the ability to provide intrastate services. Section 276(b) directs the Commission to "establish a per call compensation plan to ensure that payphone service providers are fairly compensated for each and every completed intrastate and interstate call."[152] Section 276(d) provides that "[t]o the extent that any State requirements are inconsistent with the Commission's regulations, the Commission's regulations on such matters shall preempt such State requirements."[153] None of these provisions is specifically excepted from section 2(b), yet *all* of them explicitly give the FCC jurisdiction over intrastate matters. Thus, we believe that the lack of an explicit exception in section 2(b) should not be read to require an interpretation that the Commission's jurisdiction under sections 251 and 252 is limited to interstate services. A contrary holding would nullify several explicit grants of authority to the FCC, noted above, and would render parts of the statute meaningless.[154]

94. Some parties find significance in the fact that earlier drafts of the legislation would have amended section 2(b) to make an exception for Part II of Title II, including section 251, but the enacted version did not include that exception. These parties argue that this change in drafting demonstrates an intention by Congress that the limitations of section 2(b) remain fully in force with regard to sections 251 and 252. We find this argument unpersuasive.

95. Parties that attach significance to the omission of the proposed amendment of section 2(b) rely on a rule of statutory construction providing that, when a provision in a prior draft is altered in the final legislation, Congress intended a change from the prior version. This rule of statutory construction has been rejected, however, when changes from one draft to another are not explained.[155] In this instance, the only statement from Congress regarding the meaning of the omission of the section 2(b) amendment appears in the Joint Explanatory Statement of the Conference Report. According to the Joint Explanatory Statement, all differences between the Senate Bill, the House Amendment, and the substitute reached in conference are noted therein "except for clerical corrections, conforming changes made

[151] 47 U.S.C. § 251 (e)(1).

[152] 47 U.S.C. § 276(b).

[153] 47 U.S.C. § 276(d).

[154] *See* Sprint comments at 7.

[155] *Mead Corp v. Tilley*, 490 U.S. 714, 723 (1989); *Rastelli v. Warden*, 782 F.2d 17, 23 (2d Cir. 1986); *Drummond Coal v. Watt*, 735 F.2d 469, 474 (11th Cir. 1984).

necessary by agreements reached by the conferees, and minor drafting and clerical changes."[156] Because the Joint Explanatory Statement did not address the removal of the section 2(b) amendment from the final bill, the logical inference is that Congress regarded the change as an inconsequential modification rather than a significant alteration. Moreover, it seems implausible that, by selecting the final version, Congress intended a radical alteration of the Commission's authority under section 251, given the total lack of legislative history to that effect. We conclude that elimination of the proposed amendment of section 2(b) was a nonsubstantive change because, as AT&T contends, such amendment was unnecessary in light of the grants of authority under sections 251 and 252, and would have had no practical effect.[157]

96. Some parties have argued that, to the extent that sections 251 and 252 address intrastate matters, the Commission's rulemaking authority under those sections is limited to those instances where Commission action regarding intrastate matters is specifically mandated, such as number administration. We disagree. There is no language limiting the Commission's authority to establish rules under section 251. To the contrary, section 251(d)(1) affirmatively requires Commission rules, stating that "the Commission *shall* complete *all* actions necessary to implement the requirements of *this section*."[158] Pursuant to sections 4(i), 201(b), and 303(r) of the Act, the Commission generally has rulemaking authority to implement all provisions of the Communications Act. Courts have held that the Commission, pursuant to its general rulemaking authority, has "expansive" rather than limited powers.[159] Further, where Congress has expressly delegated to the Commission rulemaking responsibility with respect to a particular matter, such delegation constitutes "something more than the normal grant of authority permitting an agency to make ordinary rules and regulations . . . ."[160] Indeed, to read these provisions otherwise would negate the requirement that states ensure that arbitrated agreements are consistent with the Commission's rules. Thus, the explicit rulemaking requirements pointed out by some of the parties is best read as giving the Commission more jurisdiction than usual, not less. We believe that the delegation of authority set forth in section 251(d)(1) is "expansive" and not limited. We therefore reject

[156] Joint Explanatory Statement at 113.

[157] AT&T reply at 4 n.5.

[158] 47 U.S.C. § 251(d)(1) (emphasis added).

[159] *National Broadcasting Co. v. United States*, 319 U.S. 190, 219 (1943); *see also Federal Communications Commission v. National Citizens Committee for Broadcasting*, 436 U.S. 775, 793 (1978).

[160] *Fulani v. FCC*, 49 F.3d 904, 909 (2d Cir. 1995) (cite omitted); *see also Kay v. FCC*, 443 F.2d 638, 640 (D.C.Cir. 1970).

assertions that the Commission has authority to establish regulations regarding intrastate matters only with respect to certain provisions of section 251, such as number administration.

97. Moreover, the Court in *Louisiana PSC* does not suggest a different result. The reasoning in *Louisiana PSC* applies to the dual regulatory system of the 1934 Act. As set forth above, however, in sections 251-253, Congress amended the dual regulatory system that the Court addressed in *Louisiana PSC*. As a result, preemption in this case is governed by the usual rule, also recognized in *Louisiana PSC*, that an agency, acting within the scope of its delegated authority, may preempt inconsistent state regulation.[161] As discussed above, Congress here has expressed an intent that our rules apply to intrastate interconnection, services, and access to network elements. Therefore, *Louisiana PSC* does not foreclose our adoption of regulations under section 251 to govern intrastate matters.

98. Parties have raised other arguments suggesting that the Commission lacks authority over intrastate matters. We are not persuaded by the argument that sections 256(c) and 261, as well as section 601(c) of the 1996 Act, evince an intent by Congress to preserve states' exclusive authority over intrastate matters. In fact, section 261 supports the finding that the Commission may establish regulations regarding intrastate aspects of interconnection, services and access to unbundled elements that the states may not supersede. Section 261(b) *generally* permits states to enforce regulations prescribed prior to the date of enactment of the 1996 Act, and to prescribe regulations after such date, if such regulations are not inconsistent with the provisions of Part II of Title II.[162] Section 261(c) *specifically* provides that nothing in Part II of Title II "precludes a State from imposing requirements on a telecommunications carrier for intrastate services that are necessary to further competition in the provision of telephone exchange service or exchange access, as long as the State's requirements are not inconsistent with this part *or the Commission's regulations to implement this part.*"[163] We conclude that state access and interconnection obligations referenced in section 251(d)(3) fall within the scope of section 261(c). Section 261(c), as the more specific provision, controls over section 261(b) for matters that fall within its scope.[164] We note, too, that section 261(c) encompasses all state requirements. It is not limited to requirements that were prescribed prior to the enactment of the 1996 Act. By providing that state requirements for *intrastate* services must be consistent with the Commission's regulations, section 261(c) buttresses our

[161] *Louisiana PSC*, 476 U.S. at 368.

[162] 47 U.S.C. § 261(b).

[163] 47 U.S.C. § 261(c) (emphasis added).

[164] *Morton v. Mancari*, 417 U.S. 535, 550-51 (1974).

conclusion that the Commission may establish regulations regarding intrastate aspects of interconnection, services, and access to unbundled elements.

99. Section 601 of the 1996 Act and section 256 also are consistent with our conclusion. Section 601(c) of the 1996 Act provides that the Act and its amendments "shall not be construed to modify, impair, or supersede Federal, State, or local law unless expressly so provided in such Act or amendments."[165] We conclude that section 251(d)(1), which requires the Commission to "establish regulations to implement the requirements of this section,"[166] and section 261(c), were expressly intended to modify federal and state law and jurisdictional authority.

100. Section 256, entitled "Coordination for Interconnectivity," has no direct bearing on the issue of the Commission's authority under section 251, because it provides only that "[n]othing *in this section* shall be construed as expanding or limiting any authority that the Commission may have under law in effect before the date of enactment of the Telecommunications Act of 1996."[167] That provision is relevant, however, as a contrast to section 251, which does not contain a similar statement that the scope of the Commission's authority is unchanged by section 251.[168]

101. We further conclude that the Commission's regulations under section 251 are binding on the states, even with respect to intrastate issues. Section 252 provides that the agreements state commissions arbitrate must comply with the Commission's regulations established pursuant to section 251. In addition, section 253 requires the Commission to preempt state or local regulations or requirements that "prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service."[169] As discussed above, section 261(c) provides further support for the conclusion that states are bound by the regulations the Commission establishes under section 251.

102. We disagree with claims that section 251(d)(3) "grandfathers" existing state regulations that are consistent with the 1996 Act, and that such state regulations need not

[165] Telecommunications Act of 1996, § 601(c)(1).

[166] 47 U.S.C. § 251(d)(1).

[167] 47 U.S.C. § 256(c) (emphasis added).

[168] *Russello v. United States*, 464 U.S. 16, 23 (1983); *Cramer v. Internal Revenue Service*, 64 F.3d 1406, 1412 (9th Cir. 1995) (where Congress includes a provision in one section of statute but omits it in another section of the same Act, it should not be implied where it is excluded).

[169] 47 U.S.C. § 253(a).

comply with the Commission's implementing regulations. Section 251(d)(3) only specifies that the Commission may not preclude enforcement of state access and interconnection requirements that are consistent with section 251, and that do not substantially prevent implementation of the requirements of section 251 or the purposes of Part II of Title II. In this Report and Order, we set forth only such rules that we believe are necessary to implement fully section 251 and the purposes of Part II of Title II. Thus, state regulations that are inconsistent with our rules may "substantially prevent implementation of the requirements of this section and the purposes of [Part II of Title II]."[170]

103. We are not persuaded by arguments that, because other provisions of the 1996 Act specifically require states to comply with the Commission's regulations, the absence of such requirement in section 251(d)(3) indicates that Congress did not intend such compliance. Section 251(d)(3) permits states to prescribe and to enforce access and interconnection requirements only to the extent that such requirements "are consistent with the requirements" of section 251[171] and do not "substantially prevent implementation" of the requirements of section 251 and the purposes of Part II of Title II.[172] The Commission is required to establish regulations to "implement the requirements of the section."[173] Therefore, in order to be consistent with the requirements of section 251 and not "substantially prevent" implementation of section 251 or Part II of Title II, state requirements must be consistent with the FCC's implementing regulations.[174]

D. Commission's Legal Authority and the Adoption of National Pricing Rules

1. Background

104. In the NPRM, we sought comment on our tentative conclusion that sections 251(c)(2), (c)(3), and (c)(6) establish the Commission's legal authority under section 251(d) to adopt pricing rules to ensure that the rates, terms, and conditions for interconnection, access to

[170] 47 U.S.C. § 251(d)(3)(C).

[171] 47 U.S.C. § 251(d)(3)(B).

[172] 47 U.S.C. § 251(d)(3)(C).

[173] 47 U.S.C. § 251(d)(1).

[174] We recognize that, in some instances, whether particular state requirements are consistent with the Commission's rules may need to be considered on a case-by-case basis.

unbundled network elements, and collocation are just, reasonable, and nondiscriminatory.[175] We also sought comment on our tentative conclusion that sections 251(b)(5) and 251(c)(4) establish our authority to define "wholesale rates" for purposes of resale, and "reciprocal compensation arrangements" for purposes of transport and termination of telecommunications services.[176] In addition, we asked parties to comment on our tentative conclusion that the Commission's statutory duty to implement the pricing requirements of section 251, as elaborated in section 252, requires that we establish pricing rules interpreting and further explaining the provisions of section 252(d). The states would then apply these rules in establishing rates pursuant to arbitrations and in reviewing BOC statements of generally available terms and conditions.[177]

105. We further sought comment on our tentative conclusion that national pricing rules would likely reduce or eliminate inconsistent state regulatory requirements, increase the predictability of rates, and facilitate negotiation, arbitration, and review of agreements between incumbent LECs and competitive providers.[178] We also sought comment on the potential consequences of the Commission not establishing specific pricing rules.[179]

2. Comments

106. *Legal Authority.* The Department of Justice, GSA/DoD, many potential new entrants, and a few state commissions maintain that the Act gives the Commission a critical role in establishing national pricing rules to ensure that the rates for interconnection, access to unbundled network elements, and collocation are just, reasonable, and nondiscriminatory.[180] They contend that section 251(d)(1) specifically directs the Commission, without limitation, to

[175] NPRM at para. 117.

[176] *Id.* at 118.

[177] *Id.* at para. 118.

[178] *Id.* at para. 119.

[179] *Id.*

[180] *See, e.g.*, DoJ comments at 24-25; GSA/DoD comments at 8, reply at 6; Teleport comments at 44; ALTS comments at 33; GST comments at 25-26; Hyperion comments at 19; ACSI comments at 53, reply at 18-19; MFS comments at 49; MCI comments at 59; Sprint comments at 42; Cox comments at 22; TCI comments at 6; Time Warner comments at 45; WinStar comments at 28, reply at 6-7; Comcast reply at 12; AT&T reply at 5; Kentucky Commission comments at 3; Wyoming Commission comments at 27; *see also* NCTA comments at 8-9; Texas Public Utility Counsel comments at 15; Jones Intercable comments at 10-12, reply at 10-13 (arguing that the Commission should adopt national binding pricing rules); New Jersey Cable Ass'n, *et al.* reply at 6-9, 11 (arguing that the pricing rules adopted by the Commission should be binding); Vanguard reply at 4-5.

develop pricing rules governing transport and termination, interconnection, the provisioning of unbundled network elements, and resale.[181] These parties maintain that nothing in sections 251 and 252 expressly precludes the Commission from establishing pricing rules for the states to apply.[182] Therefore, they argue that the broad grant of authority under section 251(d)(1) includes authority to establish pricing rules.[183]

107. On the other hand, most state commissions, BOCs, and incumbent LEC trade associations contend that nothing in the 1996 Act specifically authorizes the Commission to adopt pricing rules.[184] A group of state commissions and NARUC contend that the Commission's authority to implement the requirements of section 251 is limited to the express activities assigned to the Commission in that section, such as prescribing regulations for resale and numbering portability, determining unbundled network elements, and establishing a North American Numbering Plan Administrator (NANPA) and a cost recovery mechanism for the administrators' operations.[185] The New York Commission contends that the 1996 Act is unambiguous in reserving intrastate pricing to the states under section 252(d), and that any Commission regulations would apply only to states that do not act to open local markets to competition and to those provisions in section 251 that require specific Commission rules.[186] The Ohio Commission asserts that section 251(d)(3) explicitly provides that the Commission

[181] DoJ comments at 24-25; Sprint comments at 42; Teleport comments at 44; GST comments at 25-26.

[182] *Id*; *see also* Citizens Utilities comments at 15-16.

[183] DoJ comments at 24-25; Sprint comments at 42; Teleport comments at 44; GST comments at 25-26.

[184] *See, e.g.*, Wisconsin Commission comments at 4; Ohio Commission comments at 36-39; Florida Commission comments at 24-25; Colorado Commission comments at 10; Pennsylvania Commission comments at 10-11, 26-27; Washington Commission comments at 23; Maryland Commission comments at 11; South Carolina Commission comments at 2; Minnesota Commission reply at 2-3; Nebraska Rural Development Commission comments at 1; Virginia Commission Staff comments at 2-3; Mass. Commission comments at 4; Idaho Commission comments at 10; New York Commission comments at 10, 23, reply at 4-5; Georgia Commission comments at 2-3, 7; Arizona Commission comments at 18; District of Columbia Commission comments at 24-28 (stating that the Commission has authority to adopt non-binding guidelines that would be helpful to states); Missouri Commission comments at 7-8; Texas Commission comments at 21; Alabama Commission comments at 6, 9, 22; Maine Commission, *et al.* comments at 2-4; Illinois Commission comments at 8, 41; Indiana Commission comments at 4-5; New Hampshire Commission, *et al.* reply at 3; NARUC comments at 16-20, reply at 3-5; PacTel comments at 13, 63; SBC comments at 51-53, 70-71; BellSouth comments at 48-49, reply at 31-32; Rural Tel. Coalition comments at 24; USTA comments at 4-5; GTE comments at 59, reply at 3-5; SNET comments at 28; TDS comments at 17 n.14.

[185] NARUC comments at 14-15; Maine Commission, *et al.* comments at 2-4; *see also* GTE comments at 6-7.

[186] New York Commission comments at 2-3; *see also* Pennsylvania Commission comments at 10-11, 26-27; Virginia Commission Staff comments at 3.

shall not preclude states from enforcing or implementing the requirements of section 251, as long as the state's policy is consistent with section 251.[187]

108. The Illinois Commission states that section 252(d) governs pricing standards for interconnection and network element charges, transport and termination of traffic, and wholesale services.[188] It argues that each provision expressly establishes standards under which state commissions are to determine prices, without reference to any Commission rulemaking.[189] The Illinois Commission further contends that in establishing standards for state commissions to apply during arbitration under section 252(b), subsections 252(c)(1) and 252(c)(2) distinguish between section 251 and the Commission's regulations prescribed thereunder, and the pricing standards set forth in section 252(d), which do not reference any Commission regulations.[190] The Illinois Commission infers from these subsections that Congress did not intend for the Commission to exercise broad rulemaking authority under sections 251 and 252.[191] Other state commissions similarly argue that the general language of section 251(c)(2)(D) and the specific grant of authority to states under section 252(d) to price interconnection elements reveal Congress's intent to confer responsibility over pricing on the states.[192]

109. *National Standards.* The Department of Justice, the SBA, and most of the IXCs, CAPs, and cable companies addressing this issue agree that the Commission should establish national pricing rules for interconnection and unbundled elements under 252(d)(1) for the reasons stated in the NPRM.[193] Citizens Utilities, NEXTLINK, and WinStar also support the

[187] Ohio Commission comments at 36-39.

[188] Illinois Commission comments at 7.

[189] *Id.*

[190] *Id.* at 8, 41.

[191] *Id.*

[192] Colorado Commission comments at 10; Pennsylvania Commission comments at 10-11, 26-27; Virginia Commission comments at 2-3; Mass. Commission comments at 4; Arizona Commission comments at 18.

[193] *See, e.g.*, DoJ comments at 25-26; SBA comments at 4; LDDS comments at 19-20, 58; AT&T comments at 45; LCI comments at 3, 12; MCI comments at 59; Sprint comments at 42, reply at 5-11; CompTel comments at 19-22; Vartec, *et al.* comments at 10 (national pricing standards for databases); ALTS comments at 33; Teleport comments at 45-46, reply at 32; Hyperion comments at 3, reply at 5-6; ASCI comments at 51-53; Intermedia comments at 14; MFS comments at 52-54, 58, 64; Cable & Wireless comments at 32; Cox comments at 12, 22, reply at 5, 13-16; Comcast comments at 44; Continental comments at 16; TCI comments at 22-24, reply at 1-3; Jones Intercable comments at 2-4, reply at 3, 9; Time Warner comments at 47, reply at 2, 7-9; *see also*

Commission's tentative conclusion that national pricing rules should be adopted to guide the states in facilitating the negotiation and arbitration process.[194] The majority of consumer organizations urge the Commission to establish uniform, national rules and argue that inconsistent and unpredictable state rules would inhibit or delay the efforts of new entrants to obtain interconnection arrangements with incumbent LECs and undermine their ability to raise capital in the financial markets.[195] Several state commissions also support the adoption of national rules. For example, the Kentucky Commission contends that national pricing rules would facilitate competitive entry,[196] and the North Dakota Commission argues that such national rules would provide significant assistance to those states that have not opened their local markets to competition.[197]

110. The RBOCs, with the exception of Ameritech, generally oppose the adoption of national pricing rules on legal and policy grounds.[198] The majority of states also express opposition to national pricing rules and argue that section 251(d)(3) reserves to the states the details of local service competition.[199] Other state commissions advocate that the Commission

Vanguard reply at 3, 7-9.

[194] *See, e.g.*, Citizens Utilities comments at 15-16; NEXTLINK comments at 24-25; WinStar comments at 28; *see also* CompTel comments at 19-20.

[195] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 3-4, 11, 29-32; SDN Users Ass'n comments at 2; CFA/CU comments at 26; Competition Policy Institute comments at 9-10, reply at 10; *see also* ITIC comments at 3-5; TRACER comments at 3-4, reply at 6; NTIA reply at 15-16.

[196] *See, e.g.*, Kentucky Commission comments at 4; *see also* Texas Public Utility Counsel comments at 15.

[197] *See, e.g.*, North Dakota Commission comments at 1-2.

[198] *See, e.g.*, NYNEX comments at 40-41; SBC comments at 48, 50, reply at 29, 33; PacTel comments at 2, 8, 64, and 65, reply at 23; BellSouth comments at 49, 55, reply at 33; Ameritech comments at 59 (favoring national pricing principles that allow incumbent LECs to recover all costs); *see also* Cincinnati Bell comments at 20 (supporting FCC rules, but arguing that rules should only be general and for the purpose of guiding states in the negotiation and arbitration process).

[199] *See, e.g.*, Ohio Commission comments at 39-40; Colorado Commission comments at 28, reply at 4-6; Wyoming Commission comments at 20, 27-29; Minnesota reply at 2-3; Maryland Commission comments at 12; New York Commission comments at 11-12, reply at 9-10; Georgia Commission comments at 7, reply at 1; Indiana Commission comments at 2, 21; Alaska Commission comments at 4; Missouri Commission comments at 8; Oregon Commission comments at 30; Alabama Commission comments at 20-21; North Carolina Commission comments at 10; Maine Commission, *et al.* comments at 2-3; California Commission comments at 11-12, reply at 18; Arizona Commission comments at 19; Connecticut Commission comments at 9-10; Washington Commission reply at 2; New Hampshire Commission, *et al.* reply at 2-3; Mississippi Commission comments at 13; Pennsylvania Commission comments at 26; NARUC comments at 23, 24, reply at 12-13; Florida Commission comments at 25; *see also* Ohio Consumers' Counsel comments at 21, 27; MECA comments at 39-41; Municipal Utilities comments at 17-18, reply at 7; Attorneys General, *et al.* reply at 2, 7; Puerto Rico Tel. comments at 5-6; reply at 9-10; Alaska Tel. Ass'n comments at 2.

should adopt either preferred outcomes for interconnection that narrow the range of issues in arbitration and negotiation,[200] or general nonbinding guidelines that recognize the rights of states to adopt their own pricing standards.[201] For instance, the Illinois Commission contends that, if the Commission finds that it has authority to establish pricing rules to govern the states, it could determine that rates for interconnection and unbundled network elements are to be based upon forward-looking costs rather than historical costs, and leave all other details to the states. In addition, the Illinois Commission argues that any pricing standards that the Commission prescribes should be focused narrowly on those services addressed in section 252(d).[202] The Iowa Commission maintains that the Commission's rules may be explicit only to the extent that they prohibit state policies that are inconsistent with section 251.[203] Some incumbent LEC trade associations suggest that the Commission adopt only broad guidelines and minimum pricing requirements.[204] NADO, Joint Consumer Advocates, and the Rural Tel. Coalition oppose the adoption of any national pricing rules on the ground that such a regime would not allow for flexibility and innovation.[205] The Rural Tel. Coalition further asserts that if the Commission insists on prescribing pricing standards for all states, it must take into account the myriad of different classes of customers, geographic characteristics, population densities, and technologies.[206]

3. Discussion

111. In adopting sections 251 and 252, we conclude that Congress envisioned complementary and significant roles for the Commission and the states with respect to the

[200] *See* Washington Commission comments at 2.

[201] *See, e.g.*, Pennsylvania Commission comments at 28; South Carolina Commission comments at 3; Illinois Commission comments at 41, reply at 12-13; Washington Commission comments at 2, 22; *see also* NYNEX comments at 42.

[202] *See* Illinois Commission comments at 41-43.

[203] *See* Iowa Commission comments at 5.

[204] *See, e.g.*, NECA comments at 6; USTA comments at 37; *see also* George Washington Urban League comments at 2; Alliance for Public Technology comments at 9-11, reply at 1; ALLTEL comments at 4-7, reply at summary.

[205] *See* NADO, *et al.* at 4, 6; Joint Consumer Advocates reply at 9-10; Rural Tel. Coalition comments at 19, reply at 13-14.

[206] Rural Tel. Coalition comments at 19, reply at 14.

rates for section 251 services, interconnection, and access to unbundled elements.[207] We interpret the Commission's role under section 251 as ensuring that rates are just, reasonable, and nondiscriminatory: in doing so, we believe it to be within our discretion to adopt national pricing rules in order to ensure that rates will be just, reasonable, and nondiscriminatory. The Commission is also responsible for ensuring that interconnection, collocation, access to unbundled elements, resale services, and transport and termination of telecommunications are reasonably available to new entrants.[208] The states' role under section 252(c) is to establish specific rates when the parties cannot agree, consistent with the regulations prescribed by the Commission under sections 251(d)(1) and 252(d).

112. While we recognize that sections 201 and 202 create a very different regulatory regime from that envisioned by sections 251 and 252, we observe that Congress used terms in section 251, such as the requirement that rates, terms, and conditions be "just, reasonable, and nondiscriminatory," that are very similar to language in sections 201 and 202. This lends additional support for the proposition that Congress intended to give us authority to adopt rules regarding the justness and reasonableness of rates pursuant to section 251, comparable in some respects to the authority Congress gave us pursuant to sections 201 and 202.

113. We believe that national pricing rules are a critical component of the interconnection regime set out in sections 251 and 252. Congress intended these sections to promote opportunities for local competition, and directed us to establish regulations to ensure that rates under this regime would be economically efficient. This, in turn, should reduce potential entrants' capital costs, and should facilitate entry by all types of service providers, including small entities.[209] Further, we believe that national rules will help states review and arbitrate contested agreements in a timely fashion. From August to November and beyond, states will be carrying the tremendous burden of setting specific rates for interconnection and network elements, for resale, and for transport and termination when parties bring these issues before them for arbitration. As discussed in more detail below, we are setting forth default proxies for states to use if they are unable to set these rates using the necessary cost studies within the statutory time frame. After that, both we and the states will need to review the level of competition, revise our rules as necessary, and reconcile arbitrated interconnection arrangements to those revisions on a going-forward basis.

114. We believe that national rules should reduce the parties' uncertainty about the outcome that may be reached by different states in their respective regulatory proceedings,

[207] *See infra*, Sections VII and VIII.

[208] For a further discussion of specific pricing rules, *see infra*, Section VII.

[209] *See* Regulatory Flexibility Act, 5 U.S.C. § 601 *et seq*.

which will reduce regulatory burdens for all parties including small incumbent LECs and small entities. A national regime should also help to ensure consistent federal court decisions on review of specific state orders under sections 251 and 252.[210] In addition, under the national pricing rules that we adopt for interconnection and unbundled network elements, states will retain the flexibility to consider local technological, environmental, regulatory, and economic conditions. Failure to adopt national pricing rules, on the other hand, could lead to widely disparate state policies that could delay the consummation of interconnection arrangements and otherwise hinder the development of local competition. Lack of national rules could also provide opportunities for incumbent LECs to inhibit or delay the interconnection efforts of new competitors, and create great uncertainty for the industry, capital markets, regulators, and courts as to what pricing policies would be pursued by each of the individual states, frustrating the potential entrants' ability to raise capital. In sum, we believe that the pricing of interconnection, unbundled elements, resale, and transport and termination of telecommunications is important to ensure that opportunities to compete are available to new entrants.

115. As we observed in the NPRM,[211] section 251 explicitly sets forth certain requirements regarding rates for interconnection, access to unbundled elements, and related offerings. Sections 251(c)(2) and (c)(3) require that incumbent LECs' "*rates*, terms, and conditions" for interconnection and unbundled network elements be "just, reasonable, and nondiscriminatory in accordance with . . . the requirements of sections 251 and 252."[212] Section 251(c)(4) requires that incumbent LECs offer "for resale at wholesale *rates* any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers," without unreasonable conditions or limitations.[213] Section 251(c)(6) provides that all LECs must provide physical collocation of equipment, "on *rates*, terms, and conditions that are just, reasonable, and nondiscriminatory."[214] Section 251(b)(5) requires that all LECs "establish reciprocal *compensation* arrangements for the transport and termination of telecommunications."[215] Section 251(d)(1) further expressly directs the

[210] *See* 47 U.S.C.§ 252(e)(6).

[211] NPRM at para. 117.

[212] 47 U.S.C. §§ 251(c)(2) and (c)(3) (emphasis added).

[213] 47 U.S.C. § 251(c)(4) (emphasis added).

[214] 47 U.S.C. § 251(c)(6) (emphasis added).

[215] 47 U.S.C. § 251(b)(5) (emphasis added).

Commission, without limitation, to "complete all actions necessary to implement the requirements of [section 251]."[216]

116. Section 252 generally sets forth the procedures that state commissions, incumbent LECs, and new entrants must follow to implement the requirements of section 251 and establish specific interconnection arrangements. Section 252(c)(1) provides that "in resolving by arbitration . . . any open issues and imposing conditions upon the parties to the agreement, a State commission shall . . . ensure that such resolution and conditions meet the requirements of section 251, *including the regulations prescribed by the Commission pursuant to section 251*."[217]

117. We conclude that, under section 251(d)(1), Congress granted us broad authority to complete all actions necessary to implement the requirements of section 251, including actions necessary to ensure that rates for interconnection, access to unbundled elements, and collocation are "just, reasonable, and nondiscriminatory."[218] We also determine that the statute grants us the authority to define reasonable "wholesale rates" for purposes of services to be resold, and "reciprocal compensation" for purposes of transport and termination of telecommunications.[219] The argument advanced by the New York Commission, NARUC, and others that the Commission's implementing authority under section 251(d)(1) is limited to those provisions in section 251 that mandate specific Commission rules, such as prescribing regulations for number portability, unbundling, and resale, reads into section 251(d)(1) limiting language that the section does not contain. Congress did not confine the Commission's rulemaking authority to only those matters identified in sections 251(b)(2), 251(c)(4)(B), and 251(d)(2), and there is no basis for inferring such an implicit limitation. A narrow reading of section 251(d)(1), as proposed by the New York Commission, NARUC, and others, would require the Commission to neglect its statutory duty to implement the provisions of section 251 and to promote rapid competitive entry into local telephone markets.

118. We also reject the arguments raised by several state commissions that the language in section 252(c) indicates Congress's intent for the Commission to have little or no authority with respect to pricing of interconnection, access to unbundled elements, and collocation. We do not believe that the statutory directive that state commissions establish rates according to section 252(d) restricts our authority under section 251(d)(1). States must

[216] 47 U.S.C. § 251(d)(1).

[217] 47 U.S.C. § 252(c)(1) (emphasis added).

[218] *See* 47 U.S.C. §§ 251(c)(2), (c)(3), and (c)(6).

[219] *See* 47 U.S.C. §§ 251(b)(5) and (c)(4).

comply with both the statutory standards under section 252(d) *and* the regulations prescribed by the Commission pursuant to section 251 when arbitrating rate disputes or when reviewing BOC statements of generally available terms. Section 252(c) enumerates three requirements that states must follow in arbitrating issues.[220] These requirements are not set forth in the alternative; rather, states must comply with all three.

119. We further reject the argument that section 251(d)(3) restricts the Commission's authority to establish national pricing regulations. Section 251(d)(3) provides that the Commission shall not preclude the enforcement of any regulation, order, or policy of a state commission that, *inter alia*, is consistent with the requirements of section 251 and does not substantially prevent implementation of the requirements of section 251. This subsection, as discussed in section II.C., *supra*, is intended to allow states to adopt regulations that are not inconsistent with the Commission's rules; it does not address state policies that are inconsistent with the pricing rules established by the Commission.

120. We also address the impact of our rules on small incumbent LECs. For example, Rural Tel. Coalition argues that rigid rules, based on the properties of large urban LECs, cannot blindly be applied to small and rural LECs.[221] As discussed above, however, we believe that states will retain sufficient flexibility under our rules to consider local technological, environmental, regulatory, and economic conditions. We also note that section 251(f) may provide relief to certain small carriers.[222]

E. Authority to Take Enforcement Action

1. Background

121. The Commission's implementation of section 251 must be given full effect in arbitrated agreements and incorporated into all such agreements. There is judicial review of such arbitrated agreements, and one issue surely will be the adherence of these agreements to our rules. The Commission will have the opportunity to participate, upon request by a party or a state or by submitting an *amicus* filing, in the arbitration or the judicial review thereof. To clarify our potential role, we consider the extent of the Commission's authority to review and enforce agreements entered into pursuant to section 252. Section 252(e)(6) provides that, in "any case in which a State commission makes a determination under this section, any party aggrieved by such determination may bring an action in an appropriate Federal district court

[220] *See* 47 U.S.C. §§ 252(c)(1), (c)(2), and (c)(3).

[221] Rural Tel. Coalition reply at 14.

[222] *See* 47 U.S.C. § 251(f).

to determine whether the agreement or statement meets the requirements of section 251 and this section."[223]

122. In the NPRM, we sought comment on the relationship between sections 251 and 252 and the Commission's existing authority under section 208(a), which allows any person to file a complaint with the Commission regarding "anything done or omitted to be done by any common carrier subject to this Act, in contravention of the provisions thereof . . ."[224] We asked whether section 208 gives the Commission authority over complaints alleging violations of requirements set forth in sections 251 or 252. We also sought comment on the relationship between sections 251 and 252 and any other applicable Commission enforcement authority. We further sought comment on how we might increase the effectiveness of the Commission's enforcement mechanisms. Specifically, we asked for comment on how private rights of action might be used under the Act, and the Commission's role in speeding dispute resolution in forums used by private parties.

2. Comments

123. The majority of commenters agree that the Commission's section 208 complaint authority extends to the acts or omissions of common carriers in contravention of sections 251 and 252.[225] TCI further asserts that the Commission retains authority to issue declaratory rulings pursuant to the Administrative Procedure Act, 5 U.S.C. 554(e), and to initiate investigations pursuant to section 403 of the Communications Act.[226] Several state commissions argue, however, that allowing parties to file section 208 complaints would be inconsistent with the states' preeminent role under sections 251 and 252, at least in some circumstances. For example, the New York Commission contends that, to the extent that sections 251 and 252 apply to both interstate and intrastate services, the FCC only has authority to hear complaints regarding interstate communications.[227] The Illinois Commission asserts that a section 208 remedy would be appropriate only after an agreement is

[223] 47 U.S.C. § 252(e)(6).

[224] *See* 47 U.S.C. § 208; *see also* NPRM at para. 41.

[225] *See, e.g.*, ALTS comments at 7; AT&T comments at 10-11; BellSouth comments at 9; CompTel comments at 103; Florida Commission comments at 10-11; Ind. Cable & Telecomm. Ass'n reply at 4; Jones Intercable comments at 13-14; MCI comments at 7-8; MFS comments at 8-9; Ohio Commission comments at 17; Sprint comments at 8-9; TCI comments at 10; TCC comments at 62.

[226] TCI comments at 10.

[227] New York Commission reply; *see also* Wyoming Commission comments at 15-16.

implemented, and only to the extent the complaint does not allege that the agreement violates standards set forth in sections 251 and 252.[228]

3. Discussion

124. Consistent with our decision in *Telephone Number Portability*[229] and the views of most commenters, we conclude that parties have several options for seeking relief if they believe that a carrier has violated the standards under section 251 or 252. Pursuant to section 252(e)(6), a party aggrieved by a state commission arbitration determination under section 252 has the right to bring an action in federal district court.[230] Federal district courts may choose to stay or dismiss proceedings brought pursuant to section 252(e)(6), and refer issues of compliance with the substantive requirements of sections 251 and 252 to the Commission under the primary jurisdiction doctrine.[231] We find, however, that federal court review is not the exclusive remedy regarding state determinations under section 252. The 1996 Act is clear when it intends for a remedy to be exclusive. For example, section 252(e)(6) provides that, if a state commission fails to act, as described in section 252(e)(5), "the proceeding by the Commission under [section 252(e)(5)] and any judicial review of the Commission's actions *shall be the exclusive remedies* for a State commission's failure to act."[232] In contrast, the succeeding sentence in section 252(e)(6) provides that any party aggrieved by a state commission determination under section 252 "*may* bring an action in an appropriate Federal district court . . . ."[233]

125. The Commission also stands ready to provide guidance to states and other parties regarding the statute and our rules. In addition to the informal consultations that we hope to continue with state commissions, they or other parties may at any time seek a declaratory

[228] Illinois Commission comments at 16-18.

[229] *See Number Portability Order*.

[230] Commenters also suggest that the statute's provision for federal district court review of state public utility commission decisions is inconsistent with the 11th Amendment. That issue is not properly before the Commission since it is the federal courts that will have to determine the scope of their jurisdiction and in any case "regulatory agencies are not free to declare an act of Congress unconstitutional." *See Meredith Corp. v. FCC*, 809 F.2d 863, 873 (D.C. Cir. 1987).

[231] *See Reiter v. Cooper*, 507 U.S. 258, 268-269 (1993); *Allnet Comm. Servs. v. National Exchange Carrier Ass'n*, 965 F.2d 1118 (D.C. Cir. 1992); *see also* TCC Comments at 61.

[232] 47 U.S.C. § 252(e)(6) (emphasis added).

[233] *Id.* (emphasis added).

ruling where necessary to remove uncertainty or eliminate a controversy.[234] Because section 251 is critical to the development of competitive local markets, we intend to act expeditiously on such requests for declaratory rulings.

126. We further conclude that section 252(e)(6) does not divest the Commission of jurisdiction, in whole or in part, over complaints that a common carrier violated section 251 or 252 of the Act. Section 601(c)(1) of the 1996 Act provides that the 1996 Act "shall not be construed to modify, impair or supersede" existing federal law -- which includes the section 208 complaint process -- "unless expressly so provided."[235] Sections 251 and 252 do not divest the Commission of its section 208 complaint authority.

127. An aggrieved party could file a section 208 complaint with the Commission, alleging that the incumbent LEC or requesting carrier has failed to comply with the requirements of sections 251 and 252, including Commission rules thereunder, even if the carrier is in compliance with an agreement approved by the state commission. Alternatively, a party could file a section 208 complaint alleging that a common carrier is violating the terms of a negotiated or arbitrated agreement. We plan to initiate a proceeding to adopt expedited procedures for resolving complaints filed pursuant to section 208.

128. We note that, in acting on a section 208 complaint, we would not be directly reviewing the state commission's decision, but rather, our review would be strictly limited to determining whether the common carrier's actions or omissions were in contravention of the Communications Act.[236] Thus, consistent with our past decisions in analogous contexts,[237] we conclude that a person aggrieved by a state determination under sections 251 and 252 of the Act may elect to either bring an action for federal district court review or a section 208 complaint to the Commission against a common carrier. Such a person could, as a further alternative, pursuant to section 207, file a complaint against a common carrier with the

[234] *See* 47 C.F.R. § 1.2 (the Commission, in accordance with section 5(d) of the Administrative Procedures Act, 5. U.S.C. § 554(e), may issue a declaratory ruling terminating a controversy or removing uncertainty).

[235] Telecommunications Act of 1996, § 601(c)(1).

[236] While we would have authority to review such complaints, we note that we might decline, at least in some instances, to impose financial penalties upon a common carrier that is acting pursuant to state requirements or authorization, even if we sustain the allegations in the complaint.

[237] *See Number Portability Order, supra*; *Freemon v. AT&T*, 9 FCC Rcd 4032, 4033 (1994) (provision permitting persons aggrieved by violation of prohibition against unauthorized publication of certain communications to "bring a civil action in United States district court or any other court of competent jurisdiction" did not bar a complaint under section 208 of the Communications Act); *see also Policies Governing the Provision of Shared Telecommunications Service*, 3 FCC Rcd 6931 (1988) (the section 208 complaint process is available to resolve any specific problems that might arise regarding shared telecommunications service regulation by a state that impinges upon a federal interest).

Commission or in federal district court for the recovery of damages.[238] We are unlikely, in adjudicating a complaint, to examine the consistency of a state decision with sections 251 and 252 if a judicial determination has already been made on the issues before us.[239]

129. Finally, we clarify, as one commenter requested,[240] that nothing in sections 251 and 252 or our implementing regulations is intended to limit the ability of persons to seek relief under the antitrust laws, other statutes, or common law. In addition, in appropriate circumstances, the Commission could institute an inquiry on its own motion, 47 U.S.C. § 403, initiate a forfeiture proceeding, 47 U.S.C. § 503(b), initiate a cease-and-desist proceeding, 47 U.S.C. § 312(b), or in extreme cases, consider initiating a revocation proceeding for violators with radio licenses, 47 U.S.C. § 312(a), or referring violations to the Department of Justice for possible criminal prosecution under 47 U.S.C. § 501, 502 & 503(a).

F. Regulations of BOC Statements of Generally Available Terms

130. We noted in the NPRM that section 251 and our implementing regulations govern the states' review of BOC statements of generally available terms and conditions,[241] as well as arrangements reached through compulsory arbitration pursuant to section 252(b).[242] We tentatively concluded that we should adopt a single set of standards with which both arbitrated agreements and BOC statements of generally available terms must comply.

131. Only a few commenters addressed this issue, and most concurred with the tentative conclusion that we should apply the same requirements to both arbitrated agreements and BOC statements of generally available terms.[243] The Illinois Commission, for example, asserts that, "[s]ince the generally available terms could be viewed as a baseline against which to craft arbitrated arrangements, it is reasonable to hold both arbitrated agreements and the

[238] *See* 47 U.S.C. § 207.

[239] *Town of Deerfield v. FCC*, 992 F.2d 420, 428-430 (2d Cir. 1993).

[240] *See* MCI comments at 9.

[241] *See* 47 U.S.C. §§ 252(f) and 271(c)(2)(B).

[242] NPRM at para. 36 (*citing* 47 U.S.C. §§ 252(b), (f)).

[243] ACTA comments at 4; Arch comments at 5; BellSouth comments at 7; CompTel comments at 105; Illinois Commission comments at 14; MCI comments at 7; Sprint comments at 8.

BOC statements of generally available terms to the same standards."[244] CompTel asserts that, particularly if states require incumbent LECs to tariff the terms and conditions in agreements that are subject to arbitration, there will be few if any distinctions between arbitrated agreements and generally available terms and conditions.[245]

132. We hereby find that our tentative conclusion that we should apply a single set of standards to both arbitrated agreements and BOC statements of generally available terms is consistent with both the text and purpose of the 1996 Act. BOC statements of generally available terms are relevant where a BOC seeks to provide in-region interLATA service, and the BOC has not negotiated or arbitrated an agreement. Therefore, such statements are to some extent a substitute for an agreement for interconnection, services, or access to unbundled elements. We also find no basis in the statute for establishing different requirements for arbitrated agreements and BOC statements of generally available terms. Moreover, a single set of requirements will substantially ease the burdens of state commissions and the FCC in reviewing agreements and statements of generally available terms pursuant to sections 252 and 271.

G. States' Role in Fostering Local Competition Under Sections 251 and 252

133. As already referenced, states will play a critical role in promoting local competition, including by taking a key role in the negotiation and arbitration process. We believe the negotiation/arbitration process pursuant to section 252 is likely to proceed as follows. Initially, the requesting carrier and incumbent LEC will seek to negotiate mutually agreeable rates, terms, and conditions governing the competing carrier's interconnection to the incumbent's network, access to the incumbent's unbundled network elements, or the provision of services at wholesale rates for resale by the requesting carrier. Either party may ask the relevant state commission to mediate specific issues to facilitate an agreement during the negotiation process.

134. Because the new entrant's objective is to obtain the services and access to facilities from the incumbent that the entrant needs to compete in the incumbent's market, the negotiation process contemplated by the 1996 Act bears little resemblance to a typical commercial negotiation. Indeed, the entrant has nothing that the incumbent needs to compete with the entrant, and has little to offer the incumbent in a negotiation. Consequently, the 1996 Act provides that, if the parties fail to reach agreement on all issues, either party may seek arbitration before a state commission. The state commission will arbitrate individual issues specified by the parties, or conceivably may be asked to arbitrate the entire agreement.

[244] Illinois Commission comments at 14.

[245] Comptel comments at 105.

In the event that a state commission must act as arbitrator, it will need to ensure that the arbitrated agreement is consistent with the Commission's rules. In reviewing arbitrated and negotiated agreements, the state commission may ensure that such agreements are consistent with applicable state requirements.

135. Under the statutory scheme in sections 251 and 252, state commissions may be asked by parties to define specific terms and conditions governing access to unbundled elements, interconnection, and resale of services beyond the rules the Commission establishes in this Report and Order. Moreover, the state commissions are responsible for setting specific rates in arbitrated proceedings. For example, state commissions in an arbitration would likely designate the terms and conditions by which the competing carrier receives access to the incumbent's loops. The state commission might arbitrate a description or definition of the loop, the term for which the carrier commits to the purchase of rights to exclusive use of a specific network element, and the provisions under which the competing carrier will order loops from the incumbent and the incumbent will provision an order. The state commission may establish procedures that govern should the incumbent refurbish or replace the element during the agreement period, and the procedures that apply should an end user customer decide to switch from the competing carrier back to the incumbent or a different provider. In addition, the state commission will establish the rates an incumbent charges for loops, perhaps with volume and term discounts specified, as well as rates that carriers may charge to end users.

136. State commissions will have similar responsibilities with respect to other unbundled network elements such as the switch, interoffice transport, signalling and databases. State commissions may identify network elements to be unbundled, in addition to those elements identified by the Commission, and may identify additional points at which incumbent LECs must provide interconnection, where technically feasible. State commissions are responsible for determining when virtual collocation may be provided instead of physical collocation, pursuant to section 251(c)(6). States also will determine, in accordance with section 251(f)(1), whether and to what extent a rural incumbent LEC is entitled to continued exemption from the requirements of section 251(c) after a telecommunications carrier has made a bona fide request under section 251. Under section 251(f)(2), states will determine whether to grant petitions that may be filed by certain LECs for suspension or modification of the requirements in sections 251(b) or (c).

137. The foregoing is a representative sampling of the role that states will have in steering the course of local competition. State commissions will make critical decisions concerning a host of issues involving rates, terms, and conditions of interconnection and unbundling arrangements, and exemption, suspension, or modification of the requirements in section 251. The actions taken by a state will significantly affect the development of local competition in that state. Moreover, actions in one state are likely to influence other states,

and to have a substantial impact on steps the FCC takes in developing a pro-competitive national policy framework.

III. DUTY TO NEGOTIATE IN GOOD FAITH

A. Background

138. Section 251(c)(1) of the statute imposes on incumbent LECs the "duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties described" in sections 251(b) and(c), and further provides that "(t)he requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements."[246] In the NPRM, we asked parties to comment on the extent to which the Commission should establish national rules defining the requirements of the good faith negotiation obligation.

B. Advantages and Disadvantages of National Rules

1. Comments

139. Some potential new entrants and other parties assert that clear national guidelines will prevent incumbent LECs from abusing their bargaining power for the purpose of undermining efforts to eliminate barriers to competition.[247] Some parties also assert that, in the absence of specific rules, negotiations between potential competitors are likely to be needlessly prolonged and contentious.[248] SBA claims that delay and other anticompetitive tactics are particularly burdensome on small businesses.[249] In addition, Independent Cable & Telecommunications Ass'n expresses concern that states might establish guidelines that favor the incumbent.[250] Other parties agree that national rules defining some limited aspects of good faith can simplify both negotiations and dispute resolution, but nevertheless contend that

---

[246] 47 U.S.C. § 251(c)(1).

[247] *See, e.g.*, AT&T comments at 86-88; CEDRA comments at 1-9; TCC comments at 7-13.

[248] *See, e.g.*, ACSI comments at 7-11; AT&T comments at 86-88; Centennial Cellular Corp. comments at 2-10; Cox comments at 43-46; NCTA comments at 59-63.

[249] SBA comments at 8.

[250] Ind. Cable & Telecomm. Ass'n reply at 7.

the Commission should not establish extensive or detailed rules in this area, because the facts and tactics of various negotiations will display only a few characteristics in common.[251]

140. Some incumbent LECs and other parties contend that the FCC need not establish any rules regarding good faith negotiation, because the statute builds in a remedy of arbitration for parties that are dissatisfied with the negotiation process.[252] They maintain that national rules are inappropriate because a determination of whether a party has acted in good faith requires examination of specific facts that will not describe a pattern across the country.[253] SBC contends that national standards are inflexible, and thus will slow down the negotiation process, and that national rules are unnecessary, because the 1996 Act provides incentives for incumbents to negotiate.[254] Some parties also claim that section 252(b)(5) sets forth standards for good faith negotiation, and that provision makes no mention of a role for the FCC.[255]

2. Discussion

141. We conclude that establishing some national standards regarding the duty to negotiate in good faith could help to reduce areas of dispute and expedite fair and successful negotiations, and thereby realize Congress's goal of enabling swift market entry by new competitors. In order to address the balance of the incentives between the bargaining parties, however, we believe that we should set forth some minimum requirements of good faith negotiation that will guide parties and state commissions. As discussed above, the requirements in section 251 obligate incumbent LECs to provide interconnection to competitors that seek to reduce the incumbent's subscribership and weaken the incumbent's dominant position in the market. Generally, the new entrant has little to offer the incumbent. Thus, an incumbent LEC is likely to have scant, if any, economic incentive to reach agreement. In addition, incumbent LECs argue that requesting carriers may have incentives to

[251] *See, e.g.*, Georgia Commission comments at 6; Pennsylvania Commission comments at 19-20; SBA comments at 9; Sprint comments at 10-11; Attorneys General reply at 12-13.

[252] BellSouth comments at 10-11; Texas Commission comments at 6-8; USTA comments at 8; *see also* District of Columbia Commission comments at 14-17.

[253] *See, e.g.*, Bell Atlantic comments at 47 (*citing Amendment to the Commission's Rules Regarding a Plan for Sharing the Costs of Microwave Relocation*, WT Docket 95-157, Notice of Proposed Rulemaking, FCC 96-196 (rel. Apr. 30. 1996)); Citizens Utilities comments at 6; Illinois Commission comments at 20-21; Ohio Commission comments at 21.

[254] SBC comments at 12-15.

[255] Citizens Utilities comments at 6; SBC comments at 7, 20.

make unreasonable demands or otherwise fail to act in good faith.[256] The fact that an incumbent LEC has superior bargaining power does not itself demonstrate a lack of good faith, or ensure that a new entrant will act in good faith.

142. We agree with commenters that it would be futile to try to determine in advance every possible action that might be inconsistent with the duty to negotiate in good faith. As discussed more fully below, determining whether or not a party's conduct is consistent with its statutory duty will depend largely on the specific facts of individual negotiations. Therefore, we believe that it is appropriate to identify factors or practices that may be evidence of failure to negotiate in good faith, but that will need to be considered in light of all relevant circumstances.

143. Consistent with our discussion in Section II, above, we believe that the Commission has authority to review complaints alleging violations of good faith negotiation pursuant to section 208.[257] Penalties may be imposed under sections 501, 502 and 503 for failure to negotiate in good faith. In addition, we believe that state commissions have authority, under section 252(b)(5), to consider allegations that a party has failed to negotiate in good faith. We also reserve the right to amend these rules in the future as we obtain more information regarding negotiations under section 252.

C. Specific Practices that May Constitute a Failure to Negotiate in Good Faith

1. Comments

144. The comments included numerous suggestions regarding what might constitute a violation of the duty to negotiate in good faith. Commenters disagree about whether requiring another party to sign a nondisclosure agreement constitutes failure to negotiate in good faith. Some parties urge the Commission to prohibit nondisclosure agreements altogether,[258] but other parties assert that there may be legitimate reasons to seek nondisclosure.[259] Some parties assert that the Commission should only prohibit overly broad or restrictive nondisclosure agreements, such as agreements that cover information that is not commercially sensitive, or

[256] *See e.g.*, Bell Atlantic comments at 49; U S West comments at 40-42.

[257] We previously have held that parties may raise allegations regarding good faith negotiation pursuant to section 208. *Cellular Interconnection Proceeding*, 4 FCC Rcd 2369, 2371 (1989). The Commission also held in that case that "the conduct of good faith negotiations is not jurisdictionally severable." *Id.* at 2371.

[258] *See, e.g.*, LCI comments at 24; SBA comments at 9; TCI comments at 24.

[259] *See, e.g.*, Bell Atlantic comments at 48-49; GVNW comments at 3-4; Illinois Commission comments at 21; Sprint comments at 11-12; USTA comments at 8 n.11; U S West comments at 39-40.

that require withholding information from regulatory agencies.[260] Some potential competitors also propose that incumbents should not be permitted to refuse to negotiate until a requesting carrier signs a nondisclosure agreement.[261]

145. Commenters assert that other practices constitute a violation of the duty to negotiate in good faith. For example, most commenters on this issue agree that demands that a party limit its legal rights or remedies signal a lack of good faith.[262] Many new entrants also assert that actions that have the purpose or effect of delaying or impeding negotiations constitute failure to negotiate in good faith. For example, GST asserts parties should be required to respond within a reasonable time to a request to begin negotiations.[263] Some parties also claim that failing to respond to a proposal or participate meaningfully and with the intention of reaching agreement demonstrates a lack of good faith.[264] For instance, Time Warner contends that a party may not simply present proposals that do not include critical terms, or that it knows are unacceptable.[265] Parties also maintain that establishing preconditions, such as requiring requesting carriers to complete unnecessary forms before beginning negotiations, should be prohibited.[266]

[260] *See, e.g.*, GST comments at 5; MFS comments at 10-14; TCC comments at 9 (very broad nondisclosure agreements puts the incumbent in a powerful position, because it has information about numerous companies and the competitor does not have access to that same information); Teleport comments at 5-10; Texas Commission comments at 6-8.

[261] *See, e.g.*, ACTA comments at 6-7; Arch comments at 9-10; ITIC comments at 7-8; NCTA comments at 59-63; Teleport comments at 5-10; *accord* Washington Commission comments at 12.

[262] *See, e.g.*, ACTA comments at 6-7; Illinois Commission comments at 21; SBA comments at 9; Sprint comments at 11; TCI comments at 24; Washington Commission comments at 12.

[263] GST comments at 5; *accord* ACSI comments at 7-11; Bell Atlantic comments at 49 (refusing to schedule negotiations after making a request demonstrates bad faith); MFS comments at 10-14; Time Warner comments at 22-23.

[264] MFS comments at 10-14; Time Warner comments at 22-23.

[265] Time Warner comments at 22.

[266] ALTS comments at 12; AT&T comments at 86-88; Cox comments at 45-46; Excel comments at 8-9; Intelcom comments at 3-13; ITIC comments at 7-8; MFS comments at 10-14; LCI comments at 23; NCTA comments at 59-60; Time Warner comments at 22; Washington Commission comments at 12; NTIA reply at 6 n.14.

146. New entrants argue that the failure of an incumbent LEC to provide information necessary to conduct meaningful negotiations constitutes a refusal to negotiate in good faith.[267] Incumbent LECs similarly assert that requesting carriers should be required to provide certain information necessary to respond to their requests. For example, U S West states that an incumbent should be able to require a carrier that seeks interconnection to disclose what it wants to obtain, where, when, and for what duration.[268] U S West contends that a requesting carrier should not be permitted to demand immediate unbundling or interconnection, thereby forcing the incumbent to incur costs, while refusing to provide a proposed purchase and deployment schedule. Some incumbent LECs advocate a "bona fide request" requirement for all interconnection requests.[269] Under such a requirement, a requesting carrier would have to: (1) certify that it will make use of the services or facilities it requests within a specified period from the date of the request; (2) describe the purpose of the request; (3) specify precisely what it was requesting; and (4) agree to purchase the requested services or facilities for a minimum time. Other parties specifically object to a "bona fide request" requirement. For example, LCI states that such a requirement would force a carrier to agree to purchase services or facilities before prices and other terms and conditions have been established.[270]

147. Other practices to which some commenters object include a refusal to negotiate any proposed term or condition, or conditioning negotiation on one issue upon first reaching agreement on another issue.[271] Time Warner contends, for example, that parties should not be permitted to require agreement on non-price terms before beginning to negotiate prices.[272] Time Warner also contends that it is a failure to negotiate in good faith to link negotiations under section 252 with negotiations between parties in another context. Some parties contend that it demonstrates a lack of good faith for a party to fail to appoint a representative in

[267] *See, e.g.*, ACSI comments at 7-11; AT&T comments at 86-88; Cox comments at 45-46; GST comments at 6-7; MFS comments at 10-14 (for example, incumbent LECs must provide detailed documentation to support claims that a request to unbundle an element is technically infeasible); TCC comments at 9 (incumbent LECs must provide cost studies that underlie proposed rates); Time Warner comments at 22.

[268] U S West comments at 40-42.

[269] *See, e.g.*, Cincinnati Bell comments at 8-9; GTE comments at 15-17; PacTel comments at 16-21; TDS comments at 5-6; Anchorage Tel. Utility reply at 6-7.

[270] LCI comments at 24; *accord* GCI reply at 3.

[271] ALTS comments at 12; AT&T comments at 86-88; BellSouth comments at 10-11; Time Warner comments at 22.

[272] Time Warner comments at 26.

negotiations that has authority to bind the party it represents,[273] or at least authority to enter into tentative agreements on behalf of such party,[274] and that such failure needlessly delays negotiations. SCBA asserts that delays caused by failing to appoint an appropriate representative are particularly burdensome on small cable operators, which lack the resources to endure protracted negotiations and arbitrations.[275]

2. Discussion

148. The Uniform Commercial Code defines "good faith" as "honesty in fact in the conduct of the transaction concerned."[276] When looking at good faith, the question "is a narrow one focused on the subjective intent with which the person in question has acted."[277] Even where there is no specific duty to negotiate in good faith, certain principles or standards of conduct have been held to apply.[278] For example, parties may not use duress or misrepresentation in negotiations.[279] Thus, the duty to negotiate in good faith, at a minimum, prevents parties from intentionally misleading or coercing parties into reaching an agreement they would not otherwise have made. We conclude that intentionally obstructing negotiations also would constitute a failure to negotiate in good faith, because it reflects a party's unwillingness to reach agreement.

149. Because section 252 permits parties to seek mediation "at any point in the negotiation,"[280] and also allows parties to seek arbitration as early as 135 days after an

---

[273] AT&T comments at 86-88; CEDRA comments at 8.

[274] MFS comments at 10-14.

[275] SCBA comments at 10; *accord* Excel comments at 8-9; SBA comments at 8; Frontier reply at 6.

U.C.C. § 1-201(19) (1981); *see also* Black's Law Dictionary at 353 (Abridged ed. 1983) ("Good faith is an intangible and abstract quality with no technical meaning or statutory definition, and it encompasses, among other things, an honest belief, the absence of malice, and the absence of design to defraud or to seek an unconscionable advantage . . .").

[277] U.C.C. § 1-201 (84).

[278] Steven J. Burton and Eric G. Anderson, *Contractual Good Faith*, § 8.2.2 at 332 (1995).

[279] *Id.*, § 8.3.1 at 335-341.

[280] 47 U.S.C. § 252(a)(2).

incumbent LEC receives a request for negotiation under section 252,[281] we conclude that Congress specifically contemplated that one or more of the parties may fail to negotiate in good faith, and created at least one remedy in the arbitration process.[282] The possibility of arbitration itself will facilitate good faith negotiation. For example, parties seeking to avoid a legitimate accusation of breach of the duty of good faith in negotiation will work to provide their negotiating adversary all relevant information -- given that section 252(b)(4)(B) authorizes the state commission to require the parties "to provide such information as may be necessary for the State commission to reach a decision on the unresolved issues."[283] That provision also states that, if either party "fails unreasonably to respond on a timely basis to any reasonable request from the State commission, then the State commission may proceed on the basis of the best information available to it from whatever source derived."[284] The likelihood that an arbitrator will review the positions taken by the parties during negotiations also should discourage parties from refusing unreasonably to provide relevant information to each other or to delay negotiations.

150. We believe that determining whether a party has acted in good faith often will need to be decided on a case-by-case basis by state commissions or, in some instances the FCC, in light of all the facts and circumstances underlying the negotiations.[285] In light of these considerations, we set forth some minimum standards that will offer parties guidance in determining whether they are acting in good faith, but leave specific determinations of whether a party has acted in good faith to be decided by a state commission, court, or the FCC on a case-by-case basis.

151. We find that there may be pro-competitive reasons for parties to enter into nondisclosure agreements. A broad range of commenters, including IXCs, state commissions, and incumbent LECs, support this view. We conclude that there can be nondisclosure agreements that would not constitute a violation of the good faith negotiation duty, but we caution that overly broad, restrictive, or coercive nondisclosure requirements may well have

---

[281] 47 U.S.C. § 252(b)(1).

[282] Section 252(b)(4)(C) requires state commissions to "conclude the resolution of any unresolved issues not later than 9 months after the date on which the local exchange carrier received the request under this section." 47 U.S.C. § 252(b)(4)(C).

[283] 47 U.S.C. § 252(b)(4)(B).

[284] *Id.*

[285] This is consistent with earlier Commission decisions. *See Amendment to the Commission's Rules Regarding a Plan for Sharing the Costs of Microwave Relocation*, WT Docket 95-157, First Report and Order, FCC 96-196, at para. 20 (rel. Apr. 30, 1996).

anticompetitive effects. We therefore will not prejudge whether a party has demonstrated a failure to negotiate in good faith by requesting another party to sign a nondisclosure agreement, or by failing to sign a nondisclosure agreement; such demands by incumbents, however, are of concern and any complaint alleging such tactics should be evaluated carefully. Agreements may not, however, preclude a party from providing information requested by the FCC, a state commission, or in support of a request for arbitration under section 252(b)(2)(B).

152. We reject the general contention that a request by a party that another party limit its legal remedies as part of a negotiated agreement will in all cases constitute a violation of the duty to negotiate in good faith. A party may voluntarily agree to limit its legal rights or remedies in order to obtain a valuable concession from another party. In some circumstances, however, a party may violate this statutory provision by demanding that another waive its legal rights. For example, we agree with ALTS' contention that an incumbent LEC may not demand that the requesting carrier attest that the agreement complies with all provisions of the 1996 Act, federal regulations, and state law,[286] because such a demand would be at odds with the provisions of sections 251 and 252 that are intended to foster opportunities for competition on a level playing field. In addition, we find that it is a *per se* failure to negotiate in good faith for a party to refuse to include in an agreement a provision that permits the agreement to be amended in the future to take into account changes in Commission or state rules. Refusing to permit a party to include such a provision would be tantamount to forcing a party to waive its legal rights in the future.

153. We decline to find that other practices identified by parties constitute *per se* violations of the duty to negotiate in good faith. Time Warner contends that we should find that a party is not negotiating in good faith under section 252 if it seeks to tie resolution of issues in that negotiation to the resolution of other, unrelated disputes between the parties in another proceeding. On its face, the hypothetical practice raises concerns. Time Warner, however, did not present specific examples of how linking two independent negotiation proceedings would undermine good faith negotiations. We believe that requesting carriers have certain rights under sections 251 and 252, and those rights may not be derogated by an incumbent LEC demanding *quid pro quo* concessions in another proceeding. Parties, however, could mutually agree to link section 252 negotiations to negotiations on a separate matter. In fact, to the extent that concurrent resolution of issues could offer more potential solutions or may equalize the bargaining power between the parties, such action may be pro-competitive.[287]

---

[286] ALTS comments at Attachment A, 15.

[287] For example, an incumbent LEC that offers video programming may be negotiating for the right to use video programming owned by a cable company while the cable company is negotiating terms for interconnecting with the incumbent LEC. Addressing some or all of the issues in the two negotiations collectively could expand the options for reaching agreement, and would equalize the parties' bargaining power, because each has something that the other party desires.

154. We agree with parties contending that actions that are intended to delay negotiations or resolution of disputes are inconsistent with the statutory duty to negotiate in good faith.[288] The Commission will not condone any actions that are deliberately intended to delay competitive entry, in contravention of the statute's goals. We agree with SCBA that small entities seeking to enter the market may be particularly disadvantaged by delay. However, whether a party has failed to negotiate in good faith by employing unreasonable delaying tactics must be determined on a specific, case-by-case basis. For example, a party may not refuse to negotiate with a requesting telecommunications carrier, and a party may not condition negotiation on a carrier first obtaining state certification.[289] A determination based upon the intent of a party, however, is not susceptible to a standardized rule. If a party refuses throughout the negotiation process to designate a representative with authority to make binding representations on behalf of the party, and thereby significantly delays resolution of issues, such action would constitute failure to negotiate in good faith.[290] In particular, we believe that designating a representative authorized to make binding representations on behalf of a party will assist small entities and small incumbent LECs by centralizing communications and thereby facilitating the negotiation process.[291] On the other hand, it is unreasonable to expect an agent to have authority to bind the principal on every issue -- i.e., a person may reasonably be an agent of limited authority.

155. We agree with incumbent LECs and new entrants that contend that the parties should be required to provide information necessary to reach agreement.[292] Parties should provide information that will speed the provisioning process, and incumbent LECs must prove to the state commission, or in some instances the Commission or a court, that delay is not a

---

[288] *See United States v. American Tel. and Tel. Co.*, 524 F. Supp. 1336, 1356 and n.84 (D.D.C. 1981); *see also National Labor Relations Board v. Katz*, 369 U.S. 736, 742 (1962); *Amendment of Rules and Policies Governing the Attachment of Cable Television Hardware to Utility Poles*, 4 FCC Rcd 468, 472 (1989).

[289] *See, e.g.*, ALTS comments at 12-13 (contending that U S West has refused to start negotiations until it formed its positions regarding section 251, and that SBC has attempted to interpret and "enforce" state certification requirements).

[290] The Commission has reached a consistent conclusion in other instances. *See, e.g., Application of Gross Telecasting, Inc.*, 92 FCC 2d 250, 442 (1981); *Public Notice*, FCC Asks for Comments Regarding the Establishment of and Advisory Committee to Negotiate Proposed Regulations, 7 FCC Rcd 2370, 2372 (1992).

[291] For purposes of our analysis pursuant to the Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*, our use of the terms "small entities" and "small businesses" does not encompass "small incumbent LECs." We use the term "small incumbent LECs" to refer to any incumbent LECs that arguably might be defined by the Small Business Administration as "small business concerns."

[292] *See National Labor Relations Board v. Truitt Mfg Co.*, 351 U.S. 149, 153 (1956) (the trier of fact can reasonably conclude that a party lacks good faith if it raises assertions about inability to pay without making the slightest effort to substantiate that claim); *see also Microwave Facilities Operating in 1850-1990 MHz (2GHz) Band*, 61 F.R. 29679, 29689 (1996).

motive in their conduct. Review of such requests, however, must be made on a case-by-case basis to determine whether the information requested is reasonable and necessary to resolving the issues at stake. It would be reasonable, for example, for a requesting carrier to seek and obtain cost data relevant to the negotiation, or information about the incumbent's network that is necessary to make a determination about which network elements to request to serve a particular customer.[293] It would not appear to be reasonable, however, for a carrier to demand proprietary information about the incumbent's network that is not necessary for such interconnection.[294] We conclude that an incumbent LEC may not deny a requesting carrier's reasonable request for cost data during the negotiation process, because we conclude that such information is necessary for the requesting carrier to determine whether the rates offered by the incumbent LEC are reasonable. We find that this is consistent with Congress's intention for parties to use the voluntary negotiation process, if possible, to reach agreements. On the other hand, the refusal of a new entrant to provide data about its own costs does not appear on its face to be unreasonable, because the negotiations are not about unbundling or leasing the new entrants' networks.

156. We also find that incumbent LECs may not require requesting carriers to satisfy a "bona fide request" process as part of their duty to negotiate in good faith. Some of the information that incumbent LECs propose to include in a bona fide request requirement may be legitimately demanded from the requesting carrier; some of the proposed requirements, on the other hand, exceed the scope of what is necessary for the parties to reach agreement, and imposing such requirements may discourage new entry. For example, parties advocate that a "bona fide request" requirement should require requesting carriers to commit to purchase services or facilities for a specified period of time. We believe that forcing carriers to make such a commitment before critical terms, such as price, have been resolved is likely to impede new entry. Moreover, we note that section 251(c) does not impose any bona fide request requirement. In contrast, section 251(f)(1) provides that a rural telephone company is exempt from the requirements of 251(c) until, among other things, it receives a "bona fide request" for interconnection, services, or network elements. This suggests that, if Congress had intended to impose a "bona fide request" requirement on requesting carriers as part of their duty to negotiate in good faith, Congress would have made that requirement explicit.

---

[293] *See* discussion of technical feasibility, *infra*, Section IV. In addition, the Commission's federal advisory committee, the Network Reliability Council, has developed templates that summarize and list activities that need to occur when service providers connect their networks pursuant to defined interconnection specifications or when they are attempting to define a new network interface specification. As consensus recommendations from the Council, we presume the elements defined in the templates are "good faith" issues for negotiation. Comments of the Secretariat of the Second Network Reliability Council at 4-5 (*citing Network Reliability: The Path Forward*, (1996), Section 2, pp. 51-56).

[294] This is consistent with previous FCC determinations. *See, e.g., Amendment of Rules and Policies Governing the Attachment of Cable Television Hardware to Utility Poles*, 4 FCC Rcd 468, 472 (1989) (good faith negotiations necessitate that, at a minimum, one party must approach the other with a specific request).

D. Applicability of Section 252 to Preexisting Agreements

1. Background

157. Section 252(a)(1) provides that, "[u]pon receiving a request for interconnection, services, or network elements pursuant to section 251, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251 . . . . The agreement, including any interconnection agreement negotiated before the date of enactment of the Telecommunications Act of 1996, shall be submitted to the State commission under subsection (e) of this section."[295]

158. In the NPRM, we sought comment on whether sections 252(a)(1) and 252(e) require parties that have negotiated agreements for interconnection, services or network elements prior to the passage of the 1996 Act to submit such agreements to state commissions for approval. We also asked whether one party to such an existing agreement could compel renegotiation and arbitration in accordance with the procedures set forth in section 252.

2. Comments

159. In general, potential local competitors that addressed this issue argue that the plain language of section 251(a)(1) requires such agreements to be filed with the appropriate state commission for review under section 252(e).[296] In addition, these parties assert that, pursuant to section 252(i), the terms of such agreements must be made available to other carriers.[297] These parties claim that filing such agreements also should be required as a matter of public policy, because they provide evidence of existing interconnection terms that may provide the baseline for other negotiations,[298] and ensure that incumbents are not favoring

---

[295] 47 U.S.C. § 252(a)(1). Section 252(e) provides that "(a)ny interconnection agreement adopted by negotiation or arbitration shall be submitted for approval to the State commission." 47 U.S.C. § 252(e).

[296] *See, e.g.*, ALTS comments at 14-16; CompTel comments at 104; GST comments at 7; Jones Intercable comments at 22-23; Ohio Consumers' Counsel comments at 6; Sprint comments at 12; TCC comments at 9-10; *see also* Louisiana Commission comments at 8 (carriers must submit preexisting agreements upon request by the state commission).

[297] Section 252(i) provides that a LEC "shall make available any interconnection, service, or network element provided under an agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement." 47 U.S.C. § 252(i).

[298] AT&T comments at 88-90; Jones Intercable comments at 22-23.

some carriers over others.[299] Parties also claim that preexisting agreements will provide useful information to the states,[300] and that states should have the ability to review preexisting agreements to ensure that they comply with the 1996 Act.[301]

160. Incumbent LECs allege that the statute does not require that preexisting agreements be filed with state commissions. They contend that Congress only intended parties to file agreements negotiated pursuant to section 251.[302] These parties point out that section 252(a) specifically refers to requests for interconnection, services, or network elements "pursuant to section 251," and contend that an agreement reached prior to the enactment of the 1996 Act, by definition, could not have been negotiated pursuant to section 251.[303] Several parties suggest that the 1996 Act only requires filing of preexisting agreements that have been amended subsequent to the enactment of the 1996 Act, or that have been incorporated by reference into agreements negotiated pursuant to section 251.[304] Some commenters also contend that, as a policy matter, there is no reason to require filing of preexisting agreements. The California Commission asserts that requiring filing and review of preexisting agreements would be burdensome for states, and is unnecessary, because many states already reviewed such agreements prior to the passage of the 1996 Act.[305]

161. A related question is whether there should be a distinction between preexisting interconnection agreements between competitors within the same service area and agreements between non-competing or neighboring LECs. Several parties contend that the 1996 Act does not exempt such agreements from the filing requirement.[306] They also claim that it may be

---

[299] ALTS comments at 14-16, reply at 39-41.

[300] *See, e.g.*, AT&T comments at 88-90.

[301] *See, e.g.*, Arch comments at 9-10; Time Warner comments at 25.

[302] *See, e.g.*, BellSouth comments at 10-11; Cincinnati Bell comments at 9-10; Home Tel. comments at 2; J. Staurulakis comments at 3; F. Williamson comments at 5.

[303] *See, e.g.*, Ameritech comments at 95-96; BellSouth comments at 10-11; NYNEX reply at 15-16 (section 251(i) also applies only to agreements approved under section 252).

[304] *See, e.g.*, Ameritech comments at 95-96; BellSouth comments at 10-11.

[305] California Commission comments at 33.

[306] *See, e.g.*, Colorado Commission comments at 50; MFS comments at 66; Michigan Commission Staff comments at 20; Ohio Consumers' Counsel comments at 34; Oregon Commission comments at 33; ALTS reply at 35; Cox reply at 38-39; WinStar reply at 18-19.

difficult to monitor whether parties are competing, and that, in light of the 1996 Act, parties that did not compete in the past may do so in the future.[307] ACTA asserts that such agreements will provide the best information available on technically, economically and operationally feasible interconnection arrangements, because these agreements were reached in a noncompetitive context, where the incumbent was not striving to protect its market from competition, and therefore, as a public policy matter, they should be publicly filed.[308] ALTS states that Wisconsin and other states have already addressed this issue and reached the same conclusion.[309]

162. Incumbent LECs argue that Congress did not contemplate that agreements between non-competing LECs would be used as models for agreements between competitors,[310] and that such agreements bear no relation to competitive interconnection agreements.[311] Some parties argue that requiring preexisting agreements between noncompeting LECs would jeopardize universal service in many areas, especially where extended area service arrangements are in place.[312] NYNEX and the Rural Telephone Coalition contend that agreements between neighboring LECs fall within the provisions of section 259, which give rural LECs that lack economies of scope or scale the right to obtain or continue "infrastructure sharing" with neighboring larger LECs.[313]

163. Several parties recommend that agreements reached before enactment of the 1996 Act should be subject to a period of renegotiation.[314] For example, Sprint contends that

---

[307] *See, e.g.*, MFS comments at 67; Oregon Commission comments at 34; ALTS reply at 36; Cox reply at 39.

[308] ACTA comments at 6-8; *accord* Cox reply at 38; WinStar reply at 19.

[309] ALTS reply at 35-36. *See, e.g., Investigation of the Implementation of the Federal Telecommunications Act of 1996 in Wisconsin*, 05-TI-140 (Wisconsin Commission May 17, 1996); *In re Negotiated Interconnection Agreements of Telecommunications Carriers*, Docket No. 96-098-U (Arkansas Commission rel. Apr. 1, 1996).

[310] *See, e.g.*, NYNEX comments at 27 (*citing* Joint Explanatory Statement at 117, 120; Cong. Rec. S7893 (daily ed. June 7, 1995) (statement of Sen. Pressler)); Rural Tel. Coalition comments at 16; SBC comments at 53; USTA comments at 68-69.

[311] Cincinnati Bell comments at 9-10; MECA comments at 20-21; Texas Statewide Telephone Cooperative, Inc. reply at 8-9; U S West reply at 29-30.

[312] Home Tel. comments at 2; J. Staurulakis comments at 3; *see also* USTA comments at 69.

[313] NYNEX reply at 15; Rural Tel. Coalition reply at 12.

[314] Intermedia comments at 16; LCI comments at 24-26; Sprint comments at 12-13, reply at 13-14.

the passage of the 1996 Act constitutes a "changed circumstance" that would justify renegotiation of preexisting agreements.[315] Sprint proposes that parties should be required to file preexisting agreements with the state commission, but that parties should be given a six-month period to renegotiate before the terms of such agreements are made available to others under section 252(i). Intermedia Communications advocates that parties that signed long-term contracts with incumbent LECs before additional rights and competitive alternatives were available under the 1996 Act should be permitted to terminate those agreements, with minimal liability, for a period of six months after such competitive alternatives become available.[316] GST advocates that only non-incumbent LECs that are parties to an agreement should have the right to renegotiate contracts.[317] The Texas Commission states that parties should be permitted to renegotiate in the event that the state determines that the preexisting agreement violates section 252.[318]

164. Some parties contend that there is no basis for renegotiation of preexisting contracts.[319] The Illinois Commission maintains that parties have a legal obligation to abide by the terms of their contracts, and the 1996 Act does not affect that obligation.[320] It claims that a unilateral right to abrogate existing contracts could undo progress that has already been made to foster local competition. The Illinois Commerce Commission notes that parties may mutually agree to amend existing contracts, and that a party that already has an agreement with an incumbent may request a new agreement under section 252(i) if the interconnection, services, or access to unbundled elements it seeks are different from those encompassed in the existing agreement. Pacific Telesis asserts that requiring renegotiation and arbitration of existing agreements would waste resources and interfere with parties' settled expectations.[321]

[315] Sprint comments at 12 (pre-Act agreements were entered into under a different regulatory scheme, and without contemplation by the parties that the local market might become competitive; in addition, such contracts might be inconsistent with section 251, and states should not expend resources reviewing them); *accord* Time Warner comments at 26 (the Commission should establish "fresh look" period as it has done in other cases involving changed circumstances).

[316] Intermedia comments at 16; *accord* LCI comments at 24-26.

[317] GST comments at 7.

[318] Texas Commission comments at 7-8.

[319] *See, e.g.*, Illinois Commission comments at 23-24; Louisiana Commission comments at 8; F. Williamson comments at 5.

[320] Illinois Commission comments at 23-24.

[321] PacTel comments at 21.

3. Discussion

165. We conclude that the 1996 Act requires all interconnection agreements, "including any interconnection agreement negotiated before the date of enactment of the Telecommunications Act of 1996," to be submitted to the state commission for approval pursuant to section 252(e).[322] The 1996 Act does not exempt certain categories of agreements from this requirement. When Congress sought to exclude preexisting contracts from provisions of the new law, it did so expressly. For example, section 276(b)(3) provides that "nothing in this section shall affect any existing contracts between location providers and payphone service providers or interLATA or intraLATA carriers that are in force and effect as of the date of enactment of the Telecommunications Act of 1996."[323] Nothing in the legislative history leads us to a contrary conclusion. Congress intended, in enacting sections 251 and 252, to create opportunities for local telephone competition. We believe that this pro-competitive goal is best effected by subjecting all agreements to state commission review.

166. The first sentence in section 252(a)(1) refers to requests for interconnection "pursuant to section 251."[324] The final sentence in section 252(a)(1) requires submission to the state commission of all negotiated agreements, including those negotiated *before* the enactment of the 1996 Act. Some parties have asserted that there is a tension between those two sentences. We conclude that the final sentence of section 252(a)(1), which requires that *any* interconnection agreement must be submitted to the state commission, can and should be read to be independent of the prior sentences in section 252(a)(1). The interpretation suggested by some commenters that preexisting contracts need only be filed if they are amended subsequent to the 1996 Act, or incorporated by reference into agreements negotiated pursuant to the 1996 Act, would force us to impose conditions that were not intended by Congress.

167. As a matter of policy, moreover, we believe that requiring filing of all interconnection agreements best promotes Congress's stated goals of opening up local markets to competition, and permitting interconnection on just, reasonable, and nondiscriminatory terms. State commissions should have the opportunity to review *all* agreements, including those that were negotiated before the new law was enacted, to ensure that such agreements do not discriminate against third parties, and are not contrary to the public interest. In particular, preexisting agreements may include provisions that violate or are inconsistent with the pro-

[322] 47 U.S.C. § 252(a).

[323] 47 U.S.C. § 276(b)(3) (addressing nondiscrimination safeguards and regulations regarding payphone service).

[324] 47 U.S.C. § 252(a)(1).

competitive goals of the 1996 Act, and states may elect to reject such agreements under section 252(e)(2)(A). Requiring all contracts to be filed also limits an incumbent LEC's ability to discriminate among carriers, for at least two reasons. First, requiring public filing of agreements enables carriers to have information about rates, terms, and conditions that an incumbent LEC makes available to others. Second, any interconnection, service or network element provided under an agreement approved by the state commission under section 252 must be made available to any other requesting telecommunications carrier upon the same terms and conditions, in accordance with section 252(i).[325] In addition, we believe that having the opportunity to review existing agreements may provide state commissions and potential competitors with a starting point for determining what is "technically feasible" for interconnection.[326]

168. Conversely, excluding certain agreements from public disclosure could have anticompetitive consequences. For example, such contracts could include agreements not to compete. In addition, if we exempt agreements between neighboring non-competing LECs, those parties might have a disincentive to compete with each other in the future, in order to preserve the terms of their preexisting agreements. Such a result runs counter to the goal of the 1996 Act to encourage local service competition. Moreover, preserving such "non-competing" agreements could effectively insulate those parties from competition by new entrants. For example, if a new entrant seeking to provide competitive local service in a rural community is unable to obtain from a neighboring BOC interconnection or transport and termination on terms that are as favorable as those the BOC offers to the incumbent LEC in the rural area, the new entrant cannot effectively compete.[327] This is because the new entrant will have to charge its subscribers higher rates than the incumbent LEC charges to place calls to subscribers of the neighboring BOC.

[325] *See infra*, Section XV.B.

[326] *See, e.g.*, 47 U.S.C. §§ 251(c)(2)(B) and 251(c)(3).

[327] This analysis does not address the separate question of whether an incumbent LEC in a rural area must offer interconnection, resale services, or unbundled network elements. As discussed *infra*, Section XII, Congress provided rural carriers with an exemption from section 251(c) requirements until the state commission removes such exemption. 47 U.S.C. § 251(f)(1).

169. We find that section 259 does not compel us to reach a different conclusion regarding the application of section 252 to agreements between neighboring LECs.[328] Section 259 is limited to agreements for infrastructure sharing between incumbent LECs and telecommunications carriers that lack "economies of scale or scope," as determined in accordance with regulations prescribed by the Commission.[329] We conclude that the purpose and scope of section 259 differ significantly from the purpose and scope of section 251.[330] Section 259 is a limited and discrete provision designed to bring the benefits of advanced infrastructure to additional subscribers, in the context of the pro-competitive goals and provisions of the 1996 Act. Moreover, section 259(b)(7) requires LECs to file with the Commission or the state "any tariffs, contracts or other arrangements showing the rates, terms, and conditions under which such carrier is making available public switched network infrastructure and functions under this section."[331] We believe that this language further supports our conclusion that Congress intended agreements between neighboring LECs to be filed and available for public inspection. Commenters also have failed to persuade us that universal service is jeopardized by our finding that agreements between neighboring LECs are subject to section 252 filing and review provisions. Concerns regarding universal service should be addressed by the Federal-State Joint Board, empaneled pursuant to section 254 of the 1996 Act.[332] The Joint Board has initiated a comprehensive review of universal service issues and is considering, among other matters, access to telecommunications and information services in rural and high cost areas.[333] In addition, as discussed in Section XII, *infra*, the 1996 Act provides for exemptions, suspension, or modification of some of the requirements in section 251 for rural or smaller carriers.

[328] Section 259 requires the Commission to prescribe, within one year after the date of enactment of the 1996 Act, regulations that require incumbent LECs "to make available to any qualifying carrier such public switched network infrastructure, technology, information, and telecommunications facilities and functions as may be requested by such qualifying carrier to provide telecommunications services, or to provide access to information services . . . " 47 U.S.C. § 259(a). A "qualifying carrier" is a telecommunications carrier that "lacks economies of scale or scope," and that offers telephone exchange service, exchange access, and any other service included in universal service to all consumers in the service area without preference. 47 U.S.C. § 259(d).

[329] 47 U.S.C. § 259(d)(1).

[330] The Commission plans to initiate a proceeding to establish regulations pursuant to section 259.

[331] 47 U.S.C. § 259(b)(7).

[332] *Universal Service NPRM, supra.*

[333] *See*, 47 U.S.C. § 251(f).

170. Some parties have suggested that we provide parties an opportunity to renegotiate preexisting contracts. Parties, of course, may mutually agree to renegotiate agreements, but we decline to mandate that parties renegotiate existing contracts. In addition, as discussed below, commercial mobile radio service (CMRS) providers that are party to preexisting agreements with incumbent LECs that provide for non-mutual compensation have the option of renegotiating such agreements with no termination liabilities or contract penalties.[334] We believe that generally requiring renegotiation of preexisting contracts is unnecessary, however, because state commissions will review preexisting agreements, and may reject any negotiated agreement that "discriminates against a telecommunications carrier not a party to the agreement," or that "is not consistent with the public interest, convenience, and necessity."[335] We recognize that preexisting agreements were negotiated under very different circumstances, and may not provide a reasonable basis for interconnection agreements under the 1996 Act. For example, non-competing neighboring LECs may have negotiated terms that simply are not viable in a competitive market. It would not foster efficient long-term competition to force parties to make available to all requesting carriers interconnection on terms not sustainable in a competitive environment. In such circumstances, a state commission would have authority to reject a preexisting agreement as inconsistent with the public interest. If a state commission approves a preexisting agreement, that agreement will be available to other parties in accordance with section 252(i). Contrary to NYNEX's assertion, once a state approves an agreement under section 252(e), that agreement is "approved under" section 252.

171. We decline to require immediate filing of pre-existing agreements. States should establish procedures and reasonable time frames for requiring filing of preexisting agreements in a timely manner. We leave these procedures largely in the hands of the states in order to ensure that we do not impair some states' ability to carry out their other duties under the 1996 Act, especially if a large number of such agreements must be filed and approved by the state commission. We believe, nevertheless, that we should set an outer time period to file with the appropriate state commission agreements that Class A carriers have with other Class A carriers that pre-date the 1996 Act.[336] We conclude that setting such a time limit will ensure that third parties are not prevented indefinitely from reviewing and taking advantage of the terms of preexisting agreements. We are concerned, however, about the burden that a national filing deadline might impose on small telephone companies that have preexisting

[334] *See infra*, Section XI.A.

[335] 47 U.S.C. § 252(e)(2)(A).

[336] Class A companies are defined as companies "having annual revenues from regulated telecommunications operations of $100,000,000 or more." 47 C.F.R. § 32.11(a)(1).

agreements with Class A carriers or with other small carriers.[337] We therefore limit the filing deadline requirement to preexisting agreements between Class A carriers. We encourage all carriers to file preexisting contracts with the appropriate state commission no later than June 30, 1997, but impose this as a *requirement* only with respect to agreements between Class A carriers. We find that requiring preexisting agreements between Class A carriers to be filed no later than June 30, 1997 is unlikely to burden state commissions unduly, and will give parties a reasonable opportunity to renegotiate agreements if they so choose, while at the same time, establishing this outer time limit ensures that third parties will have access to the terms of such agreements, under section 252(i), within a reasonable period. We expect to have completed proceedings on universal service and access charges by this filing deadline. States may impose a shorter time period for filing preexisting agreements.

[337] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

IV. INTERCONNECTION

172. This section of the Report and Order, and the three sections that follow it, address the interconnection and unbundling obligations that the Act imposes on incumbent LECs. Beyond the resale of incumbent LEC services, it is these obligations that pave the way for the introduction of facilities-based competition with incumbent LECs. The interconnection obligation of section 251(c)(2), discussed in this section, allows competing carriers to choose the most efficient points at which to exchange traffic with incumbent LECs, thereby lowering the competing carriers' costs of, among other things, transport and termination of traffic. The unbundling obligation of section 251(c)(3) further permits new entrants, where economically efficient, to substitute incumbent LEC facilities for some or all of the facilities the new entrant would have had to obtain in order to compete. Finally, both the interconnection and unbundling sections of the Act, in combination with the collocation obligation imposed on incumbents by section 251(c)(6), allow competing carriers to choose technically feasible methods of achieving interconnection or access to unbundled elements.

173. Section 251(c)(2) imposes upon incumbent LECs "the duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network . . . for the transmission and routing of telephone exchange service and exchange access."[338] Such interconnection must be: (1) provided by the incumbent LEC at "any technically feasible point within [its] network;"[339] (2) "at least equal in quality to that provided by the local exchange carrier to itself or . . . [to] any other party to which the carrier provides interconnection;"[340] and (3) provided on rates, terms, and conditions that are "just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252."[341]

A. Relationship Between Interconnection and Transport and Termination

1. Background

174. In the NPRM, we sought comment on the relationship between the obligation of incumbent LECs to provide "interconnection" under section 251(c)(2) and the obligation of all LECs to establish reciprocal compensation arrangements for the "transport and termination" of

[338] 47 U.S.C. § 251(c)(2)(A).

[339] 47 U.S.C. § 251(c)(2)(B).

[340] 47 U.S.C. § 251(c)(2)(C).

[341] 47 U.S.C. § 251(c)(2)(D).

telecommunications pursuant to section 251(b)(5). We stated that the term "interconnection" might refer only to the physical linking of two networks or to both the linking of facilities and the transport and termination of traffic. We noted in the NPRM that section 252(d) sets forth different pricing standards for interconnection and transport and termination.

2. Comments

175. The BOCs, several state commissions, and other parties argue that a plain reading of section 251(c)(2) requires a determination that interconnection refers only to the physical linking of facilities.[342] In contrast, the IXCs and several other parties claim that interconnection includes both the physical connection of the facilities and the transmission and termination of traffic across that link.[343] CompTel contends that it would make no sense for Congress to require an incumbent LEC to engage in a physical linking with another network without requiring the incumbent LEC to route and terminate traffic from the other network.[344] Several parties claim that there is no inherent contradiction between the pricing standard in section 252(d)(1) for interconnection[345] and section 252(d)(2) for transport and termination[346] because, to the extent that section 252(d)(2) allows for the mutual and reciprocal recovery of each carrier's costs, the recovery could be interpreted to mean total service long run

[342] *See, e.g.*, Bell Atlantic comments at 20-21; BellSouth comments at 15; USTA comments at 9-10 (no useful purpose served by introducing ambiguity into the pricing standards that apply to the separate provisions); U S West comments at 11-12; GTE comments at 17-18 (interconnection denotes links between an incumbent LEC's network and a competitor's network while transport and termination refers to the transmission of a call from the point of interconnection to the called party); Florida Commission comments at 13; Illinois Commission comments at 29; New York Commission comments at 31; MFS comments at 15; Sprint comments at 13.

[343] *See, e.g.*, CompTel comments at 66-67; LDDS comments at 76; Texas Commission comments at 10; ACSI comments at 11.

[344] CompTel comments at 66-67.

[345] Section 252(d)(1) states that determinations by a state commission of the just and reasonable rate for interconnection pursuant to section 251(c)(2) and network elements pursuant to section 251(c)(3) shall be: (1) based on the cost determined without reference to a rate-of-return proceeding; (2) nondiscriminatory; and (3) may include a reasonable profit. 47 U.S.C. § 252(d)(1).

[346] Section 252(d)(2) states that, in connection with an incumbent LEC's compliance with section 251(b)(5), a state commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless: (1) the terms and conditions provide for mutual and reciprocal recovery of costs associated with the transport and termination of calls that originate on the network of another carrier; and, (2) such terms and conditions are a reasonable approximation of the additional costs of terminating such calls. Section 252(d)(2) explicitly states that bill-and-keep arrangements are not precluded under section 252(d)(2) and neither the Commission nor the states are authorized to establish rate regulation proceedings to establish the additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls. 47 U.S.C. § 252(d)(2).

incremental cost (TSLRIC) (including a reasonable profit) plus a reasonable contribution to joint and common costs, which is consistent with section 252(d)(1).[347]

3. Discussion

176. We conclude that the term "interconnection" under section 251(c)(2) refers only to the physical linking of two networks for the mutual exchange of traffic. Including the transport and termination of traffic within the meaning of section 251(c)(2) would result in reading out of the statute the duty of all LECs to establish "reciprocal compensation arrangements for the transport and termination of telecommunications," under section 251(b)(5).[348] In addition, in setting the pricing standard for section 251(c)(2) interconnection, section 252(d)(1) states it applies when state commissions make determinations "of the just and reasonable rate for interconnection of *facilities and equipment* for purposes of subsection (c)(2) of section 251."[349] Because section 251(d)(1) states that it only applies to the interconnection of "facilities and equipment," if we were to interpret section 251(c)(2) to refer to transport and termination of traffic as well as the physical linking of equipment and facilities, it would still be necessary to find a pricing standard for the transport and termination of traffic apart from section 252(d)(1). We also reject CompTel's argument that reading section 251(c)(2) to refer only to the physical linking of networks implies that incumbent LECs would not have a duty to route and terminate traffic. That duty applies to all LECs and is clearly expressed in section 251(b)(5). We note that because interconnection refers to the physical linking of two networks, and not the transport and termination of traffic, access charges are not affected by our rules implementing section 251(c)(2).

B. National Interconnection Rules

1. Background

177. In the NPRM, we tentatively concluded that national interconnection rules would facilitate swift entry by competitors in multiple states by eliminating the need to comply with a multiplicity of state variations in technical and procedural requirements.[350] We sought comment on this tentative conclusion.

[347] ACSI comments at 11; Texas Public Utility Counsel comments at 1, 50; Texas Commission comments at 10.

[348] 47 U.S.C. § 251(b)(5).

[349] 47 U.S.C. § 251(d)(1) (emphasis added).

[350] NPRM at paras. 50-51.

2. Comments

178. Parties raise many of the same arguments discussed above, in section II.A., regarding the advantages and disadvantages of explicit national rules for interconnection. IXCs, CAPs, cable operators, and others claim that national rules could prevent incumbent LECs from erecting artificial barriers to entry,[351] facilitate comprehensive business and network planning,[352] equalize bargaining power,[353] and expedite and simplify negotiations.[354] Other parties, including several BOCs and state commissions, argue that national rules should only be established for core requirements and should allow for state variations.[355] Some parties contend, for example, that the pace of technological change makes it impossible to create immutable and uniform interconnection rules.[356] SBC and PacTel claim that industry standards already exist for interconnection and that national standards would preclude the deployment of new technologies.[357] PacTel also claims that Commission rules requiring untested interconnection methodologies may slow competitive entry.[358]

3. Discussion

179. As discussed more fully above, we conclude that national rules regarding interconnection pursuant to section 251(c)(2) are necessary to further Congress's goal of creating conditions that will facilitate the development of competition in the telephone

[351] *See* MFS comments at 14; Teleport comments at 22; CompTel comments at 21; Ad Hoc Telecommunications Users Committee comments at 5; ACTA comments at 10; ACSI comments at 10; MCI reply at 24.

[352] *See* ACTA comments at 10; Vanguard comments at 10; Omnipoint comments at 17-18; NTIA reply at 3.

[353] *See* Teleport comments at 17; Kansas Commission comments at 5; AT&T reply at 9; MCI reply at 24; Time Warner reply at 6-7.

[354] *See* Intermedia comments at 3; Teleport reply at 8.

[355] *See, e.g.*, Ameritech comments at 11; BellSouth comments at 13-14; Bell Atlantic reply at 6-7; GTE reply at 9; Lincoln Tel. comments at 3; California Commission comments at 16; Illinois Commission comments at 25; New York Commission comments at 33; Texas Commission comments at 8; TCA comments at 4; Texas Tel. Ass'n comments at 1; F. Williamson comments at 7.

[356] *See* Ad Hoc Telecommunications Users Committee comments at 2; Citizens Utilities comments at 6-7; Rural Tel. Coalition comments at 31; Pennsylvania Commission reply at 23.

[357] SBC comments at 33; PacTel comments at 24, 28.

[358] PacTel comments at 23-24.

exchange market.[359] Uniform rules will permit all carriers, including small entities and small incumbent LECs, to plan regional or national networks using the same interconnection points in similar networks nationwide. Uniform rules will also guarantee consistent, minimum nondiscrimination safeguards and "equal in quality" standards in every state. Such rules will also avoid relitigating, in multiple states, the issue of whether interconnection at a particular point is technically feasible.

180. We believe, however, that inflexible or overly detailed national rules implementing section 251(c)(2) may inhibit the ability of the states or the parties to reach arrangements that reflect technological and market advances and regional differences. We also believe that, on several issues, the record is not adequate at this time to justify the establishment of national rules. Therefore, as required by section 251(d)(3) and as discussed in section II.C. above, our rules will permit states to go beyond the national rules discussed below, and impose additional procompetitive interconnection requirements, as long as such requirements are otherwise consistent with the 1996 Act and the Commission's regulations. We believe that we can benefit from state experience in our ongoing review of these issues.

C. Interconnection for the Transmission and Routing of Telephone Exchange Service and Exchange Access

1. Background

181. Section 251(c)(2) imposes a duty upon incumbent LECs to provide "interconnection with the [LEC's] network . . . for the transmission and routing of telephone exchange service and exchange access."[360] In the NPRM, we sought comment on whether a carrier could request interconnection pursuant to subsection (c)(2) for purposes of transmitting and routing telephone exchange service, exchange access, or both, or whether this provision requires that such a request be solely for purposes of providing *both* telephone exchange service and exchange access.[361]

2. Comments

182. The BOCs and several other parties state that a telecommunications carrier should not be able to request cost-based interconnection under section 251(c)(2) solely for the purpose of offering access services. They argue that a carrier requesting interconnection

[359] *See supra*, Section II.A.

[360] 47 U.S.C. § 251(c)(2).

[361] NPRM at para. 162.

solely under section 251(c)(2) must use that interconnection for the transmission and routing of both telephone exchange service *and* exchange access.[362] USTA concurs, and suggests that competitive access providers (CAPs) will not be harmed because, if CAPs wish to provide only exchange access, they are fully protected by the Commission's *Expanded Interconnection* rules.[363]

183. IXCs and the DOJ argue that carriers should be able to request cost-based interconnection under section 251(c)(2) solely for the purpose of offering access services. The IXCs claim that, in view of congressional intent not to limit entry into the local telecommunications market, the statute should be read to permit telecommunications carriers to provide either local exchange service, exchange access, or both.[364] DOJ and CompTel contend that permitting the use of section 251(c)(2) interconnection to provide competitive exchange access is not inconsistent with section 251(g)[365] because section 251(g) only preserves the rights of IXCs to equal access under the Commission's preexisting rules until such time that the Commission adopts new requirements. They argue that section 251(g) was not intended to limit the provision of exchange access by new entrants.[366] AT&T argues that, by requiring incumbent LECs to provide interconnection for the transmission and routing of telephone exchange access, Congress used the word "and" to make clear that incumbent LECs must make interconnection available for purposes of allowing new entrants to provide local exchange *and* exchange access, and thereby prevent incumbent LECs from claiming that, as long as they offered interconnection for at least one of these two purposes, they had met the requirement in section 251(c)(2).[367]

[362] *See, e.g.*, USTA comments at 62-64 (requiring both is in keeping with the Act's purpose of encouraging facilities-based competition); Ameritech comments at 17-19 (nothing in the Act or the legislative history indicates that Congress was concerned about exchange access service per se); Bell Atlantic comments at 8; BellSouth comments at 61; GTE comments at 75; Ohio Consumers' Counsel comments at 32.

[363] USTA comments at 65.

[364] *See, e.g.*, CompTel reply at 26, 33; AT&T reply at 24 n.40; Sprint comments at 68 n.38; DoJ comments at 44, 52; PageNet comments at 15-16 (the word "and" in the context of legislative history can be read alternatively as "and" or "or", depending on congressional intent).

[365] Section 251(g) states that each LEC "shall provide exchange access, information access, and exchange services for such access to [IXCs] and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation)" that apply prior to enactment of the 1996 Act. Section 251(g) also states that these rules shall remain in effect until the Commission "explicitly supersede[s]" them. 47 U.S.C. § 251(g).

[366] DoJ comments at 53 n.26; CompTel reply at 28.

[367] AT&T reply at 24 n.40.

3. Discussion

184. We conclude that the phrase "telephone exchange service and exchange access" imposes at least three obligations on incumbent LECs: an incumbent must provide interconnection for purposes of transmitting and routing telephone exchange traffic or exchange access traffic or both. We believe that this interpretation is consistent with both the language of the statute and Congress's intent to foster entry by competitive providers into the local exchange market.[368] Moreover, the term "local exchange carrier" is defined in the Act as "any person that is engaged in the provision of telephone exchange service *or* exchange access."[369] Thus, we believe that Congress intended to facilitate entry by carriers offering either service. In imposing an interconnection requirement under section 251(c)(2) to facilitate such entry, however, we believe that Congress did not want to deter entry by entities that seek to offer either service, or both, and, as a result, section 251(c)(2) requires incumbent LECs to interconnect with carriers providing "telephone exchange service *and* exchange access."[370] Congress made clear that incumbent LECs must provide interconnection to carriers that seek to offer telephone exchange service *and* to carriers that seek to offer exchange access. This interpretation is consistent with section 251(c)(2), which imposes an obligation on incumbent LECs, but not requesting carriers.[371] Thus, for example, an analogous requirement might be that incumbent LECs must provide interconnection for the transmission and routing of "electrical and optical signals." Such a hypothetical requirement could not rationally be read to obligate *requesting carriers* to provide both electrical and optical signals.[372]

185. We also conclude that requiring new entrants to make available both local exchange service and exchange access as a prerequisite to obtaining interconnection to the

---

[368] As the U.S. Court of Appeals for the Fifth Circuit stated in *Peacock v. Lubbock Compress Company*, "the word 'and' is not a word with a single meaning, for chameleonlike, it takes its color from its surroundings." The court held that "[i]n the construction of statutes, it is the duty of the Court to ascertain the clear intention of the legislature. In order to do this. Courts are often compelled to construe 'or' as meaning 'and,' and again 'and' as meaning 'or'." *Peacock v. Lubbock Compress Company*, 252 F.2d 892, 893 (5th Cir. 1958) (*citing United States v. Fisk*, 70 U.S. 445, 448).

[369] 47 U.S.C. § 153(26) (emphasis added).

[370] 47 U.S.C. § 251(c)(2) (emphasis added).

[371] Where Congress intended to impose obligations on requesting carriers in section 251(c), it did so expressly. For example, section 251(c)(1) includes a specific and separate requirement on requesting carriers to negotiate in good faith. 47 U.S.C. § 251(c)(1).

[372] One definition of the word "and" is "as well as." Random House College Dictionary 50 (rev. ed. 1984). Under this definition, the provision can be read, and we believe should be read, to require LECs to provide interconnection for the transmission and routing of telephone exchange service as well as exchange access.

incumbent LEC's network under subsection (c)(2) would unduly restrict potential competitors. For example, CAPs often enter the telecommunications market as exchange access providers prior to offering telephone exchange services. Further, applying separate regulatory regimes (*i.e.*, section 251 related-rules for providers of telephone exchange and exchange access services and section 201 related-rules for providers of only exchange access services) with divergent requirements to parties using essentially the same equipment to transmit and route traffic, is undesirable in light of the new procompetitive paradigm created by section 251.[373] We see no convincing justification for treating providers of exchange access services that offer telephone exchange services differently from access providers who do not offer telephone exchange services. We therefore conclude that parties offering only exchange access are permitted to seek interconnection pursuant to section 251(c)(2).

D. Interexchange Service is Not Telephone Exchange Service or Exchange Access

1. Background

186. Sections 251(c)(2) and 251(c)(3) impose duties upon incumbent LECs to provide interconnection and nondiscriminatory access to unbundled network elements to "any requesting telecommunications carrier."[374] In the NPRM, we tentatively concluded that carriers providing interexchange services are "telecommunications carriers" and thus may seek interconnection and unbundled elements under subsections (c)(2) and (c)(3). We also tentatively concluded, however, that with respect to section 251(c)(2), the statute imposes limits on the purposes for which any telecommunications carrier, including IXCs, may request interconnection pursuant to that section. Section 251(c)(2) imposes an obligation upon incumbent LECs to provide requesting carriers with interconnection if the purpose of the interconnection is for the "transmission and routing of telephone exchange service and exchange access."[375] We tentatively concluded in the NPRM that interexchange service does not appear to constitute either "telephone exchange service" or "exchange access." "Exchange access" is defined in section 3(16) as "the offering of access to telephone exchange services or facilities for the purpose of the origination or termination of telephone toll services."[376] We stated that an IXC that requests interconnection to originate or terminate an interexchange toll call is not "offering" access services, but rather is "receiving" access services.

---

[373] *See infra*, Section VI.B.2.a. for a discussion of the relationship between *Expanded Interconnection* tariffs and section 251. Competitive access providers use the same equipment in essentially the same manner as other providers of both telephone exchange and exchange access services.

[374] 47 U.S.C. §§ 251(c)(2) and (c)(3).

[375] 47 U.S.C. § 251(c)(2)(A).

[376] 47 U.S.C. § 153(16).

2. Comments

187. DOJ and the Illinois Commission agree with the Commission's tentative conclusion that IXCs may obtain interconnection pursuant to 251(c)(2) to provide exchange service and exchange access.[377] DOJ states that this would permit IXCs to participate fully in the provision of local exchange and exchange access services.[378]

188. Many parties, including several incumbent LECs and DOJ, agree with the Commission's tentative conclusion in the NPRM that carriers are not permitted to receive interconnection pursuant to 251(c)(2) solely for the purpose of originating or terminating interexchange traffic.[379] Several parties contend that, although IXCs are telecommunications carriers under the 1996 Act, they provide neither "exchange service" nor "exchange access" when they offer only long distance service to their customers.[380] Some commenters assert that an IXC requesting interconnection to originate or terminate a toll call would be receiving access services, not offering them, and thus would not fall within the definition of exchange access.[381] Parties also claim that permitting interconnection for this purpose would conflict with the plain meaning of sections 251(i)[382] and (g).[383] USTA argues that section 251(g)

[377] DoJ comments at 42-43; Illinois Commission comments at 48-49.

[378] DoJ comments at 42-43.

[379] *See, e.g.*, BellSouth comments at 60-61; NYNEX comments at 5; GTE comments at 75; DoJ comments at 42; California Commission comments at 34; Bell Atlantic reply at 4-5; PacTel reply at 36; Rural Tel. Coalition reply at 8; NYNEX reply at 7 (it is not a question of the type of party that is applying for interconnection but rather the purpose for which the interconnection is being sought).

[380] DoJ comments at 42; USTA reply at 5; BellSouth reply at 45. NYNEX argues that, although some parties contend that section 251(c)(2)(A) refers to the services that the incumbent LEC provides rather than the services the requesting carrier seeks, this is contrary to the most natural reading of the language of the statute and is inconsistent with the legislative history, which makes clear that the section was intended to apply to interconnection between LECs. NYNEX reply at 7-8.

[381] *See, e.g.*, DoJ comments at 42; USTA reply at 5; BellSouth reply at 45; PacTel reply at 36; Sprint reply at 33; Rural Tel. Coalition reply at 8.

[382] *See, e.g.*, USTA comments at 61; Bell Atlantic comments at 9; NYNEX comments at 12-13; NYNEX reply at 9-10; Rural Tel. Coalition reply at 9.

requires LECs to continue to provide exchange access service to IXCs under the Commission's existing rules. USTA claims that if Congress had intended to change the access charge regime within the timeframe for implementing section 251, it would not have granted the Joint Board, created under section 254, nine months to make recommendations to the Commission.[384] Several parties also argue that the legislative history supports the conclusion that section 251 was not designed to permit IXCs to avoid application of our current access charge rules.[385] Other carriers claim that permitting interconnection pursuant to section 251(c)(2) to allow parties to avoid access charges would be unwise from a policy perspective, because it would divest the Commission of jurisdiction over the rates for interstate exchange access services,[386] and would preempt state pricing regulations that were the result of years of consideration.[387]

189. IXCs and others argue that section 251(c)(2) permits carriers to obtain interconnection solely for the purpose of originating and terminating interexchange traffic.[388] CompTel claims that IXCs satisfy the "offering" requirement when they offer and provide

[383] *See, e.g.*, USTA comments at 61; NYNEX comments at 13; Bell Atlantic comments at 9; GTE comments at 75; Citizens Utilities comments at 22; Rural Tel. Coalition reply at 10. GTE argues that if, as some parties claim, section 251(g) preserves the Commission's access charge regime only until the Commission adopts new rules under section 251(d), this renders section 251(g) unnecessary because the need to preserve those rules does not arise until the new section 251(d) rules are implemented. GTE reply at 39. Also, GTE claims that interpreting section 251(g) as maintaining only the existing equal access and nondiscrimination requirements of the MFJ, GTE Decree, and the Commission's rules overlooks the fact that section 251(g) explicitly preserves rules regarding "receipt of compensation" for such access. *Id.*

[384] USTA comments at 61.

[385] *See, e.g.*, NECA comments at 4-5; PacTel reply at 36; Rural Tel. Coalition reply at 9-10 (the Joint Explanatory Statement (p. 123) evinces Congress's intent to preserve the Commission's access charge regime and authority over interstate access).

[386] Ameritech comments at 21; Bell Atlantic comments at 10; NYNEX comments at 78; PacTel reply at 36; Rural Tel. Coalition reply at 8.

[387] NYNEX comments at 19; NECA comments at 2-4.

[388] *See, e.g.*, AT&T reply at 23; MCI reply at 20-22; CompTel reply at 25-26; American Petroleum Institute comments at 3-13; ALTS comments at 46; Cable & Wireless comments at 28; Citizens Utilities comments at 21; Excel comments at 3 (use restrictions will hinder competition).

exchange access as an integral part of long distance service to the end-user subscribers.[389] Cable and Wireless claims that section 251(i) merely preserves the Commission's authority under section 201(a), which requires carriers to establish physical connection with each other in compliance with the Commission's rules.[390] ALTS argues that any erosion of access revenues that might occur as a result of the IXCs' migration to section 251 interconnection arrangements would not occur so rapidly as to affect incumbent LECs materially before the Commission completes its reform of the universal service subsidy flows.[391] CompTel suggests an interim plan that would permit incumbent LECs to charge non-cost-based rates for access until the Commission completes access charge reform, but would declare that until that time, incumbent LECs would be deemed not to have met the section 271 checklist for providing in-region interexchange service.[392] Excel claims that it would be unlawful under section 202(a) for an IXC to pay charges for local network connections that are substantially higher than the charges paid by other users of the same network services.[393] Finally, CompTel and MCI argue that the legislative history of section 251 supports the conclusion that IXCs are permitted to obtain interconnection pursuant to section 251.[394]

3. Discussion

[389] CompTel comments at 51-52. CompTel claims that by writing a broader "offering" requirement into the statute, the FCC would limit interconnection under section 251(c)(2) to LECs, and not "telecommunications carriers" as Congress intended. CompTel also claims that there is no feasible interpretation that would prevent IXCs, regardless of whether they "offer" exchange access, from obtaining stand-alone exchange access indirectly through co-carrier interconnection arrangements under section 251(c)(2). CompTel reply at 31-32. Cable & Wireless claims that the canons of statutory construction preclude a reading of the Act that holds that Congress provided all telecommunications providers with the ability to purchase access to unbundled elements for telecommunications services, but forbade them from interconnecting to the network in order to utilize unbundled elements for all telecommunications services. Cable & Wireless comments at 29.

[390] Cable & Wireless comments at 31.

[391] ALTS comments at 46; Citizens Utilities comments at 21; MCI reply at 21 (the loss of access charge revenues for incumbent LECs due to the Act cannot be used to deny the full benefits of section 251 to IXCs).

[392] CompTel comments at 81-87.

[393] Excel comments at 4-5.

[394] CompTel reply at 32 (although the Senate bill, S.652, expressly required requesting carriers to obtain interconnection for the purpose of providing exchange access service, Congress rewrote that provision in conference to remove the requirement that carriers obtain interconnection for the purpose of providing exchange access); MCI reply at 21 (arguments based on provisions in unenacted drafts of the Act excluding access from the local interconnection provisions are rebutted by the fact that both the House and Senate bills included provisions mandating cost-based access rates in other sections).

190. We conclude that IXCs are telecommunications carriers[395] under the 1996 Act, because they provide telecommunications services[396] (*i.e.*, "offer telecommunications for a fee directly to the public") by originating or terminating interexchange traffic. IXCs are permitted under the statute to obtain interconnection pursuant to section 251(c)(2) for the "transmission and routing of telephone exchange service and exchange access."[397] Moreover, traditional IXCs are a significant potential new local competitor and we conclude that denying them the right to obtain section 251(c)(2) interconnection lacks any legal or policy justification. Thus, all carriers (including those traditionally classified as IXCs) may obtain interconnection pursuant to section 251(c)(2) for the purpose of terminating calls originating from their customers residing in the same telephone exchange (*i.e.*, non-interexchange calls).

191. We conclude, however, that an IXC that requests interconnection solely for the purpose of originating or terminating its *interexchange* traffic, not for the provision of telephone exchange service and exchange access to others, on an incumbent LEC's network is not entitled to receive interconnection pursuant to section 251(c)(2).[398] Section 251(c)(2) states that incumbent LECs have a duty to interconnect with telecommunications providers "for the transmission and routing of telephone exchange service and exchange access."[399] A telecommunications carrier seeking interconnection only for interexchange services is not within the scope of this statutory language because it is not seeking interconnection for the purpose of providing telephone exchange service. Nor does a carrier seeking interconnection of interstate traffic only -- for the purpose of providing interstate services only -- fall within the scope of the phrase "exchange access." Such a would-be interconnector is not "offering" access to telephone exchange services. As we stated in the NPRM, an IXC that seeks to interconnect solely for the purpose of originating or terminating its own interexchange traffic

[395] 47 U.S.C. § 153(44).

[396] 47 U.S.C. § 153(46).

[397] 47 U.S.C. § 251(c)(2).

[398] As stated above, interconnection pursuant to section 251(c)(2) is merely the physical linking of facilities between two networks, and thus access charges are not implicated by the Commission's decisions regarding whether parties who seek to interconnect solely for the purpose of originating or terminating interexchange traffic on the incumbent's network are entitled to obtain interconnection pursuant to section 251(c)(2). *See supra*, Section IV.A.

[399] Section 153(47) defines telephone exchange service as "(A) service within a telephone exchange, or within a connected system of [ ] exchanges within the same exchange area operated to furnish . . . intercommunicating service of the character ordinarily furnished by a single exchange, and which is covered by the exchange service charge, or (B) comparable service provided through a system of switches, transmission equipment, or other facilities . . . ." 47 U.S.C. § 153(47). Section 153(16) states that exchange access means "the offering of access to telephone exchange services or facilities for the purpose of the origination or termination of telephone toll services." 47 U.S.C. § 153(16).

is not offering access, but rather is only obtaining access for its own traffic. Thus, we disagree with CompTel's position that IXCs are offering exchange access when they offer and provide exchange access as a part of long distance service. We conclude that a carrier may not obtain interconnection pursuant to section 251(c)(2) for the purpose of terminating interexchange traffic, even if that traffic was originated by a local exchange customer in a different telephone exchange of the same carrier providing the interexchange service, if it does not offer exchange access services to others. As we stated above, however, providers of competitive access services are eligible to receive interconnection pursuant to section 251(c)(2). Thus, traditional IXCs that offer access services in competition with an incumbent LEC (*i.e.*, IXCs that offer access services to other carriers as well as to themselves) are also eligible to obtain interconnection pursuant to section 251(c)(2). For example, when an IXC interconnects at a local switch, bypassing the incumbent LECs' transport network, that IXC may offer access to the local switch in competition with the incumbent. In such a situation, the interconnection point may be considered a section 251(c)(2) interconnection point.

E. Definition of "Technically Feasible"

1. Background

192. In addition to specifying the purposes for which carriers may request interconnection, section 251(c)(2) obligates incumbent LECs to provide interconnection within their networks at any "technically feasible point."[400] Similarly, section 251(c)(3) obligates incumbent LECs to provide access to unbundled elements at any "technically feasible point." Thus our interpretation of the term "technically feasible" applies to both sections.

193. In the NPRM, we sought comment on a "dynamic" definition of "technically feasible" that would provide flexibility for negotiating parties and the states in determining interconnection and unbundling points as network technology evolves.[401] We requested comment on the extent to which network reliability concerns should be included in a technical feasibility analysis, and tentatively concluded that, if such concerns were involved, the incumbent LEC had the burden to support such a claim with detailed information.[402] We also sought comment on the role of other considerations, such as economic burden, in determining technical feasibility under sections 251(c)(2) and 251(c)(3).[403]

---

[400] 47 U.S.C. § 251(c)(2)(B).

[401] NPRM at paras. 56-59, 87-88.

[402] *Id.* at paras. 56, 88.

[403] *Id.* at paras. 56-59, 87-88.

194. We also tentatively concluded that interconnection or access at a particular point in one LEC network evidences the technical feasibility of providing the same or similar interconnection or access in another, similarly structured LEC network.[404] Finally, we tentatively concluded that incumbent LECs have the burden of proving the technical infeasibility of providing interconnection or access at a particular point.[405]

2. Comments

195. Commenters offer a wide range of interpretations of the term "technically feasible." Many commenters urge the Commission to offer only broad guidelines with respect to technical feasibility and allow the parties and the states to determine the details.[406] Most BOCs and other LECs argue that "technically feasible" does not mean technically possible or imaginable, and that other factors should be considered in determining what points are technically feasible.[407] Other factors offered by the commenters include cost, network reliability and security, space limitations, the existence of operations support systems, quality of service provided, interoperability, field trials, performance standards, industry standards, the need for construction of new facilities, and inherent fairness.[408] USTA, SBC, and others allege that previous Commission orders have considered economic issues in technical feasibility analyses.[409] GVNW argues that small LECs should not be required to unbundle if it is economically unreasonable.[410] The Rural Telephone Coalition contends that the

---

[404] *Id.* at paras. 57, 87.

[405] *Id.* at paras. 58, 87.

[406] *See, e.g.*, USTA comments at 11; Bell Atlantic comments at 15; U S West comments at 44; BellSouth reply at 18; California Commission comments at 19; Texas Commission comments at 11; Citizens Utilities comments at 8 (parties are in the best position to determine the technical requirements and abilities).

[407] *See, e.g.*, SBC comments at 25; BellSouth comments at 16; USTA comments at 11; U S West reply at 22.

[408] *See, e.g.*, NYNEX comments at 65-66; SBC reply at 17; Ameritech comments at 16; ALLTEL comments at 7-8; Roseville Tel. comments at 5-6; U S West reply at 22; Lincoln Tel. reply at 3; *see also* USTA comments at 10-12; Florida Commission comments at 13-14; DoD comments at 6 (network reliability must be considered in technical feasibility). GVNW believes that interconnection is technically feasible if: (1) the interconnection point is a normal LEC access point for provisioning of service to its customers; (2) the LEC maintains assignment records for the point; (3) LEC personnel access facilities at the point for interconnecting other LEC facilities; (4) cross-connecting the facility at the point does not expose the network to undue damage; and (5) the LEC and requesting carriers can demonstrate the technical proficiency of personnel assigned to work at the interconnect point. GVNW comments at 18-19.

[409] *See, e.g.*, USTA comments at 12 n.16; SBC comments at 16.

[410] GVNW comments at 21-22.

Commission should recognize the differences between small and large operations, high-volume and low-volume local networks, and urban and rural carriers and networks.[411] USTA also suggests that the statute only requires incumbent LECs to provide interconnection to their networks as they are configured presently and that it does not require incumbent LECs to take risky or unreasonable steps to construct new facilities or reconfigure their networks in response to competitor requests.[412]

196. Many potential competitors argue that the definition of "technical feasibility" should be extremely broad and dynamic, to encompass the effects of future technical changes.[413] Sprint contends that the Commission should use the plain meaning of the word "feasible" in defining technical feasibility. Sprint states that Webster's Dictionary defines "feasible" as "possible of realization" and any more restrictive reading would unduly restrict the availability of interconnection.[414] Many parties contend that incumbent LECs should have the burden of proving specific points are not technically feasible.[415] Time Warner claims that any point should be presumptively technically feasible and those claiming technical infeasibility should bear the burden of proof.[416] AT&T argues that existing industry standards for interconnection at a point evidences the technical feasibility of interconnection at such a point.[417] MCI argues that technically feasible points of interconnection may be either

[411] Rural Tel. Coalition comments at 31.

[412] *See, e.g.*, USTA comments at 11; BellSouth comments at 16; SBC comments at 25; Lincoln Tel. reply at 3; Roseville Tel. comments at 5-6; Office of the Ohio Consumers' Counsel comments at 10; ALLTEL reply at 5-6.

[413] *See, e.g.*, MCI comments at 12-13; MFS comments at 15; Teleport comments at 25; Nortel comments at 7; Continental Cablevision comments at 20; NCTA comments at 32; Time Warner reply at 13 (all points should be presumptively technically feasible and those claiming technical infeasibility should bear the burden of proof); Colorado Commission comments at 18; Michigan Commission comments at 8-9; Attorneys General of Connecticut *et al.* reply at 4 n.2; Hyperion comments at 10; Independent Cable & Telcomm. Ass'n reply at 9.

[414] Sprint reply at 16; ACSI reply at 6.

[415] *See, e.g.*, MCI comments at 11; Continental Cablevision comments at 20; CompTel comments at 41; Sprint comments at 14; Cox comments at 42; AT&T reply at 11; DoJ comments at 19; California Commission comments at 19; Alabama Commission comments at 15; Ohio Commission comments at 25; Colorado Commission comments at 19.

[416] Time Warner reply at 13; MCI reply at 23 (incumbent LECs do not argue that interconnection points are not technically feasible but rather that the Commission reverse its tentative conclusion that the burden of proof falls on incumbent LECs to demonstrate technical infeasibility); Cable & Wireless comments at 13 (technical feasibility can be assessed by examining the type and quality of interconnection an incumbent LEC already provides to itself, its affiliates and co-carriers).

[417] AT&T comments at 33.

physical, for facilities and equipment, or logical, for software and databases.[418] Several parties ask the Commission to make clear that technical feasibility does not require that operations support systems for order processing, provisioning and installation, billing, and other support functions be in place in order to make a specific interconnection point technically feasible.[419] Several competing carriers also contend that economic factors should not be considered in determining technically feasibile points of interconnection and access to unbundled elements. They argue that if incumbent LECs are not required to expend any funds or resources to provide for technically feasible interconnection or access, competing carriers will be limited to the services currently offered by the incumbents.[420]

197. Some parties propose specific definitions of technical feasibility. For example, Sprint defines "technically feasible" as "possible to accomplish without a scientific or technological breakthrough, *i.e.*, without an advance in the state of the art."[421] MFS defines the term as "any point in an [incumbent LEC's] network where suitable transmission, cross-connect or switching facilities are present to permit the routing of traffic to and from another network."[422]

3. Discussion

198. We conclude that the term "technically feasible" refers solely to technical or operational concerns, rather than economic, space, or site considerations. We further conclude that the obligations imposed by sections 251(c)(2) and 251(c)(3) include modifications to incumbent LEC facilities to the extent necessary to accommodate interconnection or access to network elements. Specific, significant, and demonstrable network reliability concerns associated with providing interconnection or access at a particular point, however, will be regarded as relevant evidence that interconnection or access at that point is technically infeasible. We also conclude that preexisting interconnection or access at a particular point evidences the technical feasibility of interconnection or access at substantially similar points.

[418] MCI comments at 12; IDCMA reply at 6-7.

[419] *See, e.g.*, MCI comments at 12, Sprint reply at 16-17; AT&T reply at 10 (the need for additional investment to make an arrangement available should not result in a determination of technical infeasibility); Time Warner reply at 15, 17; ACTA comments at 10;

[420] *See, e.g.*, AT&T comments at 14-20; MCI reply at 23-29; Sprint reply at 16; Time Warner reply at 16.

[421] Sprint reply at 15-16; Time Warner reply at 13 (any point of interconnection should be presumptively technically feasible).

[422] MFS comments at 15.

Finally, we conclude that incumbent LECs must prove to the appropriate state commission that a particular interconnection or access point is not technically feasibile.

199. We find that the 1996 Act bars consideration of costs in determining "technically feasible" points of interconnection or access. In the 1996 Act, Congress distinguished "technical" considerations from economic concerns. Section 251(f), for example, exempts certain rural LECs from "unduly economically burdensome" obligations imposed by section 251(c) even where satisfaction of such obligations is "technically feasible."[423] Similarly, section 254(h)(2)(A) treats "technically feasible" and "economically reasonable" as separate requirements.[424] Finally, we note that the House committee that considered H.R. 1555 (which was combined with Senate Bill S.652 to form the 1996 Act) dropped the term "economically reasonable" from its unbundling provision. The House committee explicitly addressed this substantive change, reporting that "this requirement could result in certain unbundled . . . elements . . . not being made available."[425] Thus, the deliberate and explained substantive omission of explicit economic requirements in sections 251(c)(2) and 251(c)(3) cannot be undone through an interpretation that such considerations are implicit in the term "technically feasible." Of course, a requesting carrier that wishes a "technically feasible" but expensive interconnection would, pursuant to section 252(d)(1), be required to bear the cost of that interconnection, including a reasonable profit.[426]

200. USTA and SBC cite the Commission's *900 Service* order[427] as support for the contention that costs must be considered in a technical feasibility analysis.[428] In that order, the Commission concluded that "[i]n defining 'technically feasible,' we balance both technical and economic considerations with a view toward providing [900] blocking capability to consumers without imposing undue economic burdens on LECs."[429] Our *900 Service* order,

[423] 47 U.S.C. § 251(f)(1)(A).

[424] 47 U.S.C. § 254(h)(2)(A).

[425] H. Rep. 104-204, 71 (1995).

[426] *See* 47 U.S.C. § 252(d)(1); *see also infra*, Section VII (concluding that requesting carriers must pay incumbent LECs the cost of interconnection or unbundling).

[427] *Policies and Rules Concerning Interstate 900 Telecommunications Services*, Report and Order, 6 FCC Rcd 6166, 6174 (1991) *(900 Service)*.

[428] USTA comments at 12 n.16; SBC reply at 16.

[429] *900 Service* at 6174.

however, has little bearing on our interpretation of the term "technically feasible" in the 1996 Act. As stated above, the 1996 Act distinguishes technical considerations from the "undue economic burdens" considered in the *900 Service* order. Indeed, Congress used virtually the same language—"unduly economically burdensome"—in drawing the distinction.[430] If, as SBC contends, we are to presume that Congress was aware of the Commission's analysis of the technical feasibility of 900 call blocking,[431] the 1996 Act appears squarely to reject that view of technical feasibility. Moreover, unlike the costs of providing 900 call blocking, which we imposed largely on LECs in the *900 Service* order, as noted above, to the extent incumbent LECs incur costs to provide interconnection or access under sections 251(c)(2) or 251(c)(3), incumbent LECs may recover such costs from requesting carriers.

201. In addition to economic considerations, section 251(c)(6) distinguishes considerations of "space limitations" from those of "technical reasons," and thus, in general, we believe existing space or site restrictions should not be included within a technical feasibility analysis.[432] Of course, under section 251(c)(6) "space" restrictions are expressly considered along with "technical" considerations in determining whether an incumbent LEC must provide for physical collocation. Where physical collocation is not practical because of "space limitations," however, incumbent LECs must provide for virtual collocation.[433] Section 251 is silent as to whether an incumbent LEC's duty to provide for virtual collocation or other methods of interconnection or access to unbundled elements is dependent on space constraints. We conclude, as a practical matter, that space limitations at a particular network site, without any possibility of expansion, may render interconnection or access at that point infeasible, technically or otherwise. Where such expansion is possible, however, we conclude that, in light of the distinction drawn in section 251(c)(6), site restrictions do not represent a "technical" obstacle. Again, however, the requesting party would bear the cost of any necessary expansion. Nor do we believe the term "technical," when interpreted in accordance with its ordinary meaning as referring to engineering and operational concerns in the context of sections 251(c)(2) and 251(c)(3),[434] includes consideration of accounting or billing restrictions.

[430] *See* 47 U.S.C. § 251(f)(1)(A).

[431] SBC reply at 16 ("Presumably Congress was aware of this FCC definition of the term "technically feasible" when Congress chose to use it in the 1996 Act.").

[432] 47 U.S.C. § 251(c)(6).

[433] *Id.*

[434] *See* Random House College Dictionary at 1349 ("6. pertaining to or connected with the mechanical or industrial arts and the applied sciences").

202. Several parties also attempt to draw a distinction between what is "feasible" under the terms of the statute, and what is "possible." The words "feasible" and "possible," however, are used synonymously. Feasible is defined as "capable of being accomplished or brought about; possible."[435] The statute itself provides a more meaningful distinction. Unlike the "technically *feasible*" terminology included in sections 251(c)(2) and 251(c)(3), section 251(c)(6) uses the term "*practical* for technical reasons" in determining the scope of an incumbent LEC's obligation to provide for physical collocation.[436] "Practical" is defined as "manifested in practice or action . . . not theoretical or ideal"[437] or "adapted or designed for actual use; useful," and connotes similarity to ordinary usage.[438] Thus, it is reasonable to interpret Congress's use of the term "feasible" in sections 251(c)(2) and 251(c)(3) as encompassing more than what is merely "practical" or similar to what is ordinarily done. That is, use of the term "feasible" implies that interconnecting or providing access to a LEC network element may be feasible at a particular point even if such interconnection or access requires a novel use of, or some modification to, incumbent LEC equipment. This interpretation is consistent with the fact that incumbent LEC networks were not designed to accommodate third-party interconnection or use of network elements at all or even most points within the network. If incumbent LECs were not required, at least to some extent, to adapt their facilities to interconnection or use by other carriers, the purposes of sections 251(c)(2) and 251(c)(3) would often be frustrated. For example, Congress intended to obligate the incumbent to accommodate the new entrant's network architecture by requiring the incumbent to provide interconnection "for the facilities and equipment" of the new entrant. Consistent with that intent, the incumbent must accept the novel use of, and modification to, its network facilities to accommodate the interconnector or to provide access to unbundled elements.

203. We also conclude, however, that legitimate threats to network reliability and security must be considered in evaluating the technical feasibility of interconnection or access to incumbent LEC networks. Negative network reliability effects are necessarily contrary to a finding of technical feasibility. Each carrier must be able to retain responsibility for the management, control, and performance of its own network. Thus, with regard to network reliability and security, to justify a refusal to provide interconnection or access at a point requested by another carrier, incumbent LECs must prove to the state commission, with clear

[435] The American Heritage College Dictionary 499 (1993). Webster's Ninth New Collegiate Dictionary 453 (1989). Both "feasible" and "possible" refer to that which is "capable of being realized" *Id.* at 918.

[436] 47 U.S.C. § 251(c)(6) (emphasis added).

[437] Webster's at 923.

[438] Random House College Dictionary 1040 (rev. ed. 1984).

and convincing evidence, that specific and significant adverse impacts would result from the requested interconnection or access. The reports of the Commission's Network Reliability Council discuss network reliability considerations, and establish templates that list activities that need to occur when service providers connect their networks pursuant to defined interconnection specifications or when they are attempting to define a new network interface specification.[439]

204. We further conclude that successful interconnection or access to an unbundled element at a particular point in a network, using particular facilities, is substantial evidence that interconnection or access is technically feasible at that point, or at substantially similar points in networks employing substantially similar facilities. In comparing networks for this purpose, the substantial similarity of network facilities may be evidenced, for example, by their adherence to the same interface or protocol standards. We also conclude that previous successful interconnection at a particular point in a network at a particular level of quality constitutes substantial evidence that interconnection is technically feasible at that point, or at substantially similar points, at that level of quality. Although most parties agree with this conclusion, some LECs contend that such comparisons are all but impossible because of alleged variability in network technologies, even where the ultimate services offered by separate networks are the same. We believe that, if the facilities are substantially similar, the LECs' contention is adequately addressed.

205. Finally, because sections 251(c)(2) and 251(c)(3) impose duties upon incumbent LECs, we conclude that incumbent LECs must prove to the appropriate state commission that interconnection or access at a point is not technically feasible. Incumbent LECs possess the information necessary to assess the technical feasibility of interconnecting to particular LEC facilities. Further, incumbent LECs have a duty to make available to requesting carriers general information indicating the location and technical characteristics of incumbent LEC network facilities. Without access to such information, competing carriers would be unable to make rational network deployment decisions and could be forced to make inefficient use of their own and incumbent LEC facilities, with anticompetitive effects.

206. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, the Rural Telephone Coalition argues that the Commission should set interconnection points in a flexible manner to recognize the differences between carriers and regions. We do not adopt the Rural Telephone Coalition's position because we believe that, in general, the Act does not permit incumbent LECs to deny interconnection or access to unbundled elements for any reason other than a showing that it is not technically feasible. We believe that this interpretation will advance the procompetitive goals of the

[439] *Network Reliability: A Report to the Nation* (1993, National Engineering Consortium); *Network Reliability: The Path Forward* (1996, Internet: http://www.fcc.gov/oet/nrc).

statute. We also note, however, that section 251(f) of the 1996 Act provides relief to certain small LECs from our regulations implementing section 251.

F. Technically Feasible Points of Interconnection

1. Background

207. In the NPRM, we requested comment on which points within an incumbent LEC's network constitute "technically feasible" points for purposes of section 251(c)(2).[440] Having defined the phrase "technically feasible" above, we now determine a minimum set of technically feasible points of interconnection.

2. Comments

208. Incumbent LECs claim that the specific points of interconnection should either be left to the negotiation process, or that the Commission should require interconnection only at core points, and leave all other points to the negotiation process.[441] For example, Ameritech claims that it is only technically feasible for competitors to interconnect at its end or tandem offices.[442] Bell Atlantic asserts that the trunk- and loop-side of the local switch, transport facilities, tandem facilities, and the signal transfer points (STPs) are the only technically feasible points for interconnection.[443] Potential competitors, on the other hand, argue that interconnection is technically feasible, and should be mandated by the Commission, at numerous points in the incumbent LEC's network.[444] AT&T, for example, argues that interconnection is technically feasible: (1) at the loop concentrator; (2) between the loop feeder element and the competitive provider's switch; (3) between the incumbent LEC's switch and the competitive provider's operator systems; (4) between a competitive provider's switch and a LEC's signaling A link; (5) between a competitive provider's signaling A link

[440] NPRM at paras. 56-59.

[441] *See, e.g.*, USTA comments at 10-11; BellSouth comments at 15-19; NYNEX comments at 65 (points of interconnection should be left to negotiation); Ameritech comments at 13-14; PacTel comments at 21-22; Oregon Commission comments at 25-26.

[442] Ameritech comments at 13-14; Ohio Commission comments at 24.

[443] Bell Atlantic comments at 20-21; Lincoln Tel. comments at 5.

[444] ALTS comments at 18 (interconnection should be available at any technically feasible point regardless of the technical fabric of the network at the requested point); MCI comments at 12-13 (technically feasible points may be either physical, for facilities and equipment, or logical, for software and databases); Time Warner reply at 15 (interconnection should not be limited to "core requirements" because the statute mandates interconnection at any technically feasible point).

and an incumbent LEC's STP; (6) between a competitive provider's dedicated transport and an incumbent LEC's office; and, (7) between incumbent LEC and non-incumbent LEC STPs.[445] MFS argues that, regardless of the specific points listed by the Commission, states should be able to expand the list of technically feasible points.[446]

3. Discussion

209. We conclude that we should identify a minimum list of technically feasible points of interconnection that are critical to facilitating entry by competing local service providers. Section 251(c)(2) gives competing carriers the right to deliver traffic terminating on an incumbent LEC's network at any technically feasible point on that network, rather than obligating such carriers to transport traffic to less convenient or efficient interconnection points. Section 251(c)(2) lowers barriers to competitive entry for carriers that have not deployed ubiquitous networks by permitting them to select the points in an incumbent LEC's network at which they wish to deliver traffic. Moreover, because competing carriers must usually compensate incumbent LECs for the additional costs incurred by providing interconnection, competitors have an incentive to make economically efficient decisions about where to interconnect.[447]

210. We conclude that, at a minimum, incumbent LECs must provide interconnection at the line-side of a local switch (at, for example, the main distribution frame), the trunk-side of a local switch; the trunk interconnection points for a tandem switch; and central office cross-connect points in general. This requirement includes interconnection at those out-of-band signaling transfer points necessary to exchange traffic and access call related databases. All of these points of interconnection are used today by competing carriers, noncompeting carriers, or LECs themselves for the exchange of traffic, and thus we conclude that interconnection at such points is technically feasible.

211. A varied group of commenters, including Bell Atlantic and AT&T, agree that interconnection at the line-side of the switch is technically feasible.[448] Interconnection at this

[445] Letter from Bruce Cox and Betsy Brady, AT&T, to Regina M. Keeney, Common Carrier Bureau, FCC, March 21, 1996, at 29-32 (AT&T March 21 Letter).

[446] MFS comments at 14.

[447] *See* Robert S. Pendyck and Daniel L. Rubinfeld, Microeconomics (2nd ed. 1992).

[448] *See, e.g.*, Bell Atlantic comments at 20-21; NYNEX comments at 65; BellSouth reply at 23; AT&T March 21 Letter at 30.

point is currently provided to some commercial mobile radio service (CMRS) carriers[449] and may be necessary for other competitors that have their own distribution plant, but seek to interconnect to the incumbent's switch. We also agree with numerous commenters that claim that interconnection at the trunk-side of a switch is technically feasible and should be available upon request.[450] Interconnection at this point is currently used by competing carriers to exchange traffic with incumbent LECs. Interconnection to tandem switching facilities is also currently used by IXCs and competing access providers, and is thus technically feasible. Finally, central office cross-connect points, which are designed to facilitate interconnection, are natural points of technically feasible interconnection to, for example, interoffice transmission facilities. There may be rare circumstances where there are true technical barriers to interconnection at the line- or trunk-side of the switch or at central office cross-connect points, however, the parties have not presented us with any such circumstances. Thus, incumbent LECs must prove to the state commissions that such points are not technically feasible interconnection points.

212. We also note that the points of access to unbundled elements discussed below may also serve as points of interconnection (*i.e.*, points in the network that may serve as places where potential competitors may wish to exchange traffic with the incumbent LEC other than for purposes of gaining access to unbundled elements), and thus we incorporate those points by reference here. Finally, as noted above, we have identified a minimum list of technically feasible interconnection points: (1) the line-side of a local switch; (2) the trunk-side of a local switch; (3) the trunk interconnection points for a tandem switch; (4) central office cross-connect points; (5) out-of-band signaling transfer points; and (6) the points of access to unbundled elements. In addition, we anticipate and encourage parties and the states, through negotiation and arbitration, to identify additional points of technically feasible interconnection. We believe that the experience of the parties and the states will benefit our ongoing review of interconnection.

G. Just, Reasonable, and Nondiscriminatory Rates, Terms, and Conditions of Interconnection

1. Background

213. Section 251(c)(2)(D) requires that incumbent LECs provide interconnection "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[451] In the NPRM,

[449] AT&T comments in CC Docket No. 95-185 at 6 n.6 (Mar. 4, 1996).

[450] *See, e.g.*, Bell Atlantic comments at 20-21; BellSouth reply at 23; NYNEX comments at 65; Lincoln Tel. comments at 5.

[451] 47 U.S.C. §§ 251(c)(2)(D), 251(c)(3).

we sought comment on whether we should adopt national requirements governing the terms and conditions of providing interconnection. We also sought comment on how we should determine whether the terms and conditions for interconnection arrangements are just, reasonable, and nondiscriminatory, and how we should enforce such rules. In particular, we sought comment on whether we should adopt national guidelines governing installation, service, maintenance, and repair of the incumbent LEC's portion of interconnection facilities.[452]

2. Comments

214. MCI argues that incumbent LECs should not be permitted to set restrictions on the type of traffic that can be combined on a single trunk group unless signaling requirements dictate the need for separate trunk groups. Rather, MCI argues that incumbent LECs should be required to accept one-way and two-way trunk groups.[453] MCI also urges the Commission to require incumbents and competitors to select one point of interconnection (POI) on the other carrier's network at which to exchange traffic. MCI further requests that this POI be the location where the costs and responsibilities of the transporting carrier ends and the terminating carrier begins.[454] NEXTLINK argues that incumbent LECs should only be permitted to require earnest fees of new entrants if such fees are required of other incumbent LEC customers.[455]

215. Many incumbent LECs, state commissions, and others oppose explicit national rules regarding standards for just, reasonable, and nondiscriminatory terms of interconnection

[452] We discuss the rates for interconnection below in Section VII.

[453] MCI comments at 40-41.

[454] Under MCI's proposal, new entrants would be considered co-carriers with incumbent LECs, and each carrier that seeks to interconnect with an incumbent LEC would be required to designate, for each local calling area, at least one point of interconnection (POI) on the other carrier's network. A carrier could designate more than one POI but could not be required to do so. Interconnection would result in the termination of a competing carrier's traffic at at least the same level of service quality that the incumbent LEC provides for terminating its own traffic, without any additional charge to the competing carrier to obtain that level of service. MCI comments at 40-46.

[455] NEXTLINK comments at 19.

and claim that these issues are best resolved through negotiation and arbitration.[456] Several commenters urge the Commission to adopt a rule that only requires that terms and conditions for interconnection points be nondiscriminatory.[457] BellSouth argues that longstanding nondiscrimination reporting requirements have never revealed a problem in the area of installation, maintenance, and repair.[458] Bell Atlantic contends that all arrangements provided by the incumbent LEC for a competitor should be made reciprocal, because new business buildings or residential developments may have only facilities owned by a new entrant. Absent a reciprocity requirement, Bell Atlantic contends that incumbent LECs could be at a competitive disadvantage in competing for those customers. Bell Atlantic also argues that reciprocal interconnection will put a check on potentially unrealistic unbundling requests.[459]

3. Discussion

216. We conclude that minimum national standards for just, reasonable, and nondiscriminatory terms and conditions of interconnection will be in the public interest and will provide guidance to the parties and the states in the arbitration process and thereafter. We believe that national standards will tend to offset the imbalance in bargaining power between incumbent LECs and competitors and encourage fair agreements in the marketplace between parties by setting minimum requirements that new entrants are guaranteed in arbitrations. Negotiations between an incumbent and a new entrant differ from commercial negotiations in a competitive market because new entrants are dependent solely on the incumbent for interconnection.

[456] *See, e.g.*, Ameritech comments at 16-17; BellSouth comments at 20; USTA comments at 18; GTE comments at 21; SNET comments at 14; Alabama Commission comments at 15; California Commission comments at 20; Oregon Commission comments at 26-27; GVNW comments at 15; MECA comments at 25; Ohio Consumers' Counsel comments at 12 (an effective complaint procedure should be adopted rather than overly specific guidelines). The Ohio Commission and PacTel state that performance standards governing installation, maintenance and repair are unnecessary. PacTel contends that states and industry fora such as the Ordering and Billing Forum (OBF) can establish the necessary rules without Commission intervention. PacTel comments at 29; Ohio Commission comments at 26.

[457] *See, e.g.*, Bell Atlantic comments at 31; BellSouth comments at 20-21; SBC comments at 37; GTE reply at 11; California Commission comments at 20; District of Columbia Commission comments at 18-19; Ohio Consumers' Counsel comments at 12.

[458] BellSouth comments at 20-21; *see also* Bell Atlantic comments at 31 (provisioning interconnection and unbundled elements for new entrants is complicated and requires more work than provisioning simple dial tone; the Commission should not mandate that LECs provide interconnection and unbundled elements using the appropriate installation, service, and maintenance intervals that apply to LEC customers and services); Rural Tel. Coalition comments at 32-33 (service intervals for small and rural LECs with respect to provision of interconnection should only be equal to those which the LEC achieves for itself).

[459] Bell Atlantic comments at 32.

217. Section 202(a) of the Act states that "[i]t shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges, practices, . . . facilities, or services for or in connection with like communication service . . . by any means or device, or to make or give any undue or unreasonable preference or advantage to any particular person."[460] By comparison, section 251(c)(2) creates a duty for incumbent LECs "to provide . . . any requesting telecommunications carrier, interconnection with a LEC's network on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[461] The nondiscrimination requirement in section 251(c)(2) is not qualified by the "unjust or unreasonable" language of section 202(a). We therefore conclude that Congress did not intend that the term "nondiscriminatory" in the 1996 Act be synonymous with "unjust and unreasonable discrimination" used in the 1934 Act, but rather, intended a more stringent standard.

218. Given that the incumbent LEC will be providing interconnection to its competitors pursuant to the purpose of the 1996 Act, the LEC has the incentive to discriminate against its competitors by providing them less favorable terms and conditions of interconnection than it provides itself. Permitting such circumstances is inconsistent with the procompetitive purpose of the Act. Therefore, we reject for purposes of section 251, our historical interpretation of "nondiscriminatory," which we interpreted to mean a comparison between what the incumbent LEC provided other parties in a regulated monopoly environment. We believe that the term "nondiscriminatory," as used throughout section 251, applies to the terms and conditions an incumbent LEC imposes on third parties as well as on itself. In any event, by providing interconnection to a competitor in a manner less efficient than an incumbent LEC provides itself, the incumbent LEC violates the duty to be "just" and "reasonable" under section 251(c)(2)(D). Also, incumbent LECs may not discriminate against parties based upon the identity of the carrier (*i.e.*, whether the carrier is a CMRS provider, a CAP, or a competitive LEC). As long as a carrier meets the statutory requirements, as discussed in this section, it has a right to obtain interconnection with the incumbent LEC pursuant to section 251(c)(2).

219. We identify below specific terms and conditions for interconnection in discussing physical or virtual collocation (*i.e.*, two methods of interconnection).[462] We conclude here, however, that where a carrier requesting interconnection pursuant to section 251(c)(2) does not carry a sufficient amount of traffic to justify separate one-way trunks, an incumbent LEC must accommodate two-way trunking upon request where technically feasible. Refusing to

[460] 47 U.S.C. § 202(a).

[461] 47 U.S.C. § 251(c)(2)(D).

[462] *See infra*, Section VI.

provide two-way trunking would raise costs for new entrants and create a barrier to entry. Thus, we conclude that if two-way trunking is technically feasible, it would not be just, reasonable, and nondiscriminatory for the incumbent LEC to refuse to provide it.

220. Finally, as discussed below,[463] we reject Bell Atlantic's suggestion that we impose reciprocal terms and conditions on incumbent LECs and requesting carriers pursuant to section 251(c)(2). Section 251(c)(2) does not impose on non-incumbent LECs the duty to provide interconnection. The obligations of LECs that are not incumbent LECs are generally governed by sections 251(a) and (b), not section 251(c). Also, the statute itself imposes different obligations on incumbent LECs and other LECs (*i.e.*, section 251(b) imposes obligations on all LECs while section 251(c) obligations are imposed only on incumbent LECs). We do note, however, that 251(c)(1) imposes upon a requesting telecommunications carrier a duty to negotiate the terms and conditions of interconnection agreements in good faith. We also conclude that MCI's POI proposal, permitting interconnecting carriers, both competitors and incumbent LECs, to designate points of interconnection on each other's networks, is at this time best addressed in negotiations and arbitrations between parties.[464] We believe that the record on this issue is not sufficiently persuasive to justify Commission action at this time. As market conditions evolve, we will continue to review and revise our rules as necessary.

H. Interconnection that is Equal in Quality

1. Background

221. Section 251(c)(2)(C) requires that the interconnection provided by an incumbent LEC be "at least equal in quality to that provided by the [incumbent LEC] to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection."[465] In the NPRM, we sought comment on how to determine whether interconnection is "equal in quality."

2. Comments

[463] *See infra*, Section XI.A.

[464] Of course, requesting carriers have the right to select points of interconnection at which to exchange traffic with an incumbent LEC under section 251(c)(2).

[465] 47 U.S.C. § 251(c)(2)(C).

222. MFS claims that the incumbent LEC should provide to everyone the highest grade service it makes available to anyone, including neighboring non-competing LECs.[466] MFS also claims that traffic exchange facilities between incumbent LECs and competitors should be designed to meet at least the same technical criteria and grade of service standards (*e.g.*, probability of blocking in peak hours and transmission standards) as used by the incumbent for the inter-office trunks used in its network.[467] Other parties claim that any criteria established by the Commission should not be overly detailed and quantitative or microscopic.[468] The Pennsylvania Commission suggests that "equal in quality" should mean interconnection that is virtually identical to that received by the incumbent LEC itself or its affiliate with no noticeable differences between the two to the end-user.[469] Nortel claims that the definition of "equal in quality" should recognize differences across technologies.[470]

223. Some parties argue that no national standards for "equal in quality" are necessary, and that this determination is best left to a case-by-case determination.[471] GTE claims that it should be acceptable for states to define equal in quality in terms of perception by the end user.[472]

3. Discussion

224. We conclude that the equal in quality standard of section 251(c)(2)(C) requires an incumbent LEC to provide interconnection between its network and that of a requesting carrier at a level of quality that is at least indistinguishable from that which the incumbent provides itself, a subsidiary, an affiliate, or any other party. We agree with MFS that this duty requires incumbent LECs to design interconnection facilities to meet the same technical

[466] MFS comments at 17 (even if higher grade service is offered to a non-competing LEC, the incumbent LEC must offer this service to competitors); Intermedia comments at 4.

[467] MFS comments at 17.

[468] *See, e.g.*, Ameritech comments at 17; Pennsylvania Commission comments at 21; Ohio Consumers' Counsel comments at 13.

[469] Pennsylvania Commission comments at 21.

[470] Nortel comments at 9.

[471] *See, e.g.*, BellSouth comments at 22; USTA comments at 18; GTE comments at 22; Citizens Utilities comments at 11; Alabama Commission comments at 16; Ohio Consumers' Counsel comments at 13 (dispute resolution process should ultimately decide the success or failure of quality-oriented requirements).

[472] GTE comments at 22.

criteria and service standards, such as probability of blocking in peak hours and transmission standards, that are used within their own networks. Contrary to the view of some commenters, we further conclude that the equal in quality obligation imposed by section 251(c)(2) is not limited to the quality perceived by end users. The statutory language contains no such limitation, and creating such a limitation may allow incumbent LECs to discriminate against competitors in a manner imperceptible to end users, but which still provides incumbent LECs with advantages in the marketplace (*e.g.*, the imposition of disparate conditions between carriers on the pricing and ordering of services).

225. We also note that section 251(c)(2) requires interconnection that is "at least" equal in quality to that enjoyed by the incumbent LEC itself. This is a minimum requirement. Moreover, to the extent a carrier requests interconnection of superior or lesser quality than an incumbent LEC currently provides, the incumbent LEC is obligated to provide the requested interconnection arrangement if technically feasible. Requiring incumbent LECs to provide upon request higher quality interconnection than they provide themselves, subsidiaries, or affiliates will permit new entrants to compete with incumbent LECs by offering novel services that require superior interconnection quality. We also conclude that, as long as new entrants compensate incumbent LECs for the economic cost of the higher quality interconnection,[473] competition will be promoted.[474]

[473] *See infra*, Section VII.

[474] *See also* Section VII.E. (discussion of accommodation of interconnection).

V. ACCESS TO UNBUNDLED NETWORK ELEMENTS

A. Commission Authority to Identify Unbundled Network Elements

1. Background

226. Section 251(c)(3) imposes a duty on incumbent LECs to "provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252."[475] This section also requires incumbent LECs to provide these elements "in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service."[476]

227. Section 251(d)(1) provides that "the Commission shall complete all actions necessary to establish regulations to implement the requirements of" section 251 by August 8, 1996.[477] Section 251(d)(2) further provides that, "[i]n determining what network elements should be made available for purposes of subsection (c)(3), the Commission shall consider, at a minimum, whether (A) access to such network elements as are proprietary in nature is necessary; and (B) the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[478]

228. In the NPRM, we sought comment on our tentative conclusion that the 1996 Act requires the Commission to identify network elements that incumbent LECs are required to make available to requesting carriers on an unbundled basis under section 251(c)(3).[479]

[475] 47 U.S.C. § 251(c)(3).

[476] *Id.*

[477] *Id.* at § 251(d)(1).

[478] *Id.* at § 251(d)(2).

[479] NPRM at para. 77.

2. Comments

229. The majority of parties who commented on this issue, including IXCs, potential local competitors, the Department of Justice, state commissions, incumbent LECs, cable interests, and NARUC, agree with our tentative conclusion that sections 251(d)(1) and 251(d)(2) obligate the Commission to identify network elements for purposes of subsection (c)(3).[480] BellSouth, in contrast, interprets section 251(c)(3) as requiring the Commission to identify network elements only when a state commission has failed to carry out its responsibilities under section 252, and the Commission assumes those responsibilities under section 252(e)(5).[481]

3. Discussion

230. We affirm our tentative conclusion in the NPRM that the 1996 Act requires the Commission to identify network elements that incumbent LECs must offer requesting carriers on an unbundled basis under section 251(c)(3). Section 251(d)(1) directs the Commission to establish rules implementing the requirements of section 251(c)(3). Further, section 251(d)(2) contemplates that, pursuant to this direction, the Commission will identify unbundled network elements. We conclude that neither the language in section 251(d), nor any other part of the 1996 Act, is reasonably susceptible to the interpretation advanced by BellSouth that our obligation to identify unbundled network elements arises only when we act under section 252(e)(5).

B. National Requirements for Unbundled Network Elements

1. Background

231. In the NPRM, we noted Congress's view that, when new entrants begin providing services in local telephone markets, it is unlikely they will own network facilities that completely duplicate those of incumbent LECs because of the significant investment and time required to build such facilities.[482] The statutory requirement imposed on incumbent LECs to provide access to unbundled network elements will permit new entrants to offer competing local services by purchasing from incumbents, at cost-based prices, access to

---

[480] *See, e.g.*, AT&T comments at 3-16, reply at 16; MFS comments at 36; USTA comments at 20-22; Sprint comments at 21-22; Cable & Wireless comments at 17-19; Ameritech comments at 34; District of Columbia Commission comments at 21-22; ALTS comments at 24-26; NCTA comments at 35-40; DoJ comments at 8-15; TDS comments at 5-6; TCC comments at 11-13; Hyperion reply at 5; Minnesota Commission reply at 8; *accord* GTE comments at 24; NARUC comments at 32.

[481] BellSouth comments at 26-30.

[482] NPRM at para. 75 n.103 *citing* (Joint Explanatory Statement at 148).

elements which they do not already possess, unbundled from those elements that they do not need.[483]

232. It is possible that there will be sufficient demand in some local telephone markets to support the construction of competing local exchange facilities that duplicate most or even all of the elements of an incumbent LEC's network. In these markets new entrants will be able to use unbundled elements from the incumbent LEC to provide services until such time as they complete the construction of their own networks, and thus, no longer need to rely on the facilities of an incumbent to provide local exchange and exchange access services. It is also possible, however, that other local markets, now and even into the future, may not efficiently support duplication of all, or even some, of an incumbent LEC's facilities. Access to unbundled elements in these markets will promote efficient competition for local exchange services because, under the scheme set out in the 1996 Act, such access will allow new entrants to enter local markets by obtaining use of the incumbent LECs' facilities at prices that reflect the incumbents' economies of scale and scope.[484]

233. In the NPRM, we tentatively concluded that the Commission should identify a minimum number of elements that incumbent LECs must make available to requesting carriers on an unbundled basis.[485] We further tentatively concluded that section 252(e)(3) preserves a state's authority, during arbitration, to impose additional unbundling requirements beyond those we specify, as long as such requirements are consistent with the 1996 Act and our regulations.[486] Finally, we tentatively concluded that we have authority to identify additional or different unbundling requirements in the future, as we learn about changes in technology, the innovation of new services, and the necessities of competition.[487]

---

[483] NPRM at paras. 75-76.

[484] For a further discussion of the differences between entry into local markets through access to unbundled elements and resale, *see infra*, Section V.H.

[485] NPRM at para. 77.

[486] NPRM at para. 78 and nn.105 & 106. Section 252(e) discusses a state commission's obligations regarding the approval or rejection of agreements between incumbent LECs and requesting telecommunications carriers for interconnection, services or network elements. Subparagraph (3) of this section specifically provides that a state commission is not prohibited "from establishing or enforcing other requirements of State law in its review of an agreement," as long as such requirements do not violate the terms of the statute. 47 U.S.C. § 252(e)(3). We further note that under section 252(f)(2) states may impose additional unbundling requirements during review of BOC statements of generally available terms and conditions. Section 252(f)(2) states that "(e)xcept as provided in section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of such statement . . ." 47 U.S.C. § 252(f)(2).

[487] NPRM at para. 77.

2. Comments

234. A majority of the commenters addressing this issue support our tentative conclusion that we should identify a minimum list of network elements that incumbent LECs must offer upon request.[488] These commenters argue that, absent national rules, negotiations conducted under section 252 will not proceed as Congress intended, because incumbent LECs have no incentive to provide new entrants with facilities that will be used to compete against them.[489] They contend that a national list of required unbundled elements will hasten the development of local competition and decrease the costs of entry into local telephone markets.[490] For example, they argue that national unbundling requirements will allow carriers entering local markets on a regional or national scale to take advantage of economies of scale

[488] *See, e.g.*, AT&T comments at 3-18; MFS comments at 36; Sprint comments at 21-22; Time Warner comments at 44-45; Cable & Wireless comments at 17-19; MCI comments at 12-20; Continental comments at 16; Comcast comments at 5-9, 20-21; SCG comments at 1-4; NCTA comments at 35-39; LDDS comments at 16; TCC comments at 27; Frontier comments at 13; American Mobile Telecomm. Ass'n comments at 1-8; Omnipoint comments at 17-18; SBC comments at 4; NYNEX comments at 61-64; Ameritech comments at 34; U S West comments at 43-50; Ericsson comments at 2-3; District of Columbia Commission comments at 21; Connecticut Commission comments at 9; Ad Hoc Telecommunications Users Committee comments at 13-14; Citizens Utilities comments at 12; Missouri Commission comments at 7; Nortel comments at 9-11; Cincinnati Bell comments at 15; Ohio Consumers' Counsel comments at 17; North Carolina Commission comments at 21; Illinois Commission comments at 35-36; Washington Commission comments at 19; Municipal Utilities reply at 3-6; Joint Consumer Advocates reply at 7; Attorneys General reply at 6; ATSI reply at 8-9; *accord* Wyoming Commission reply at 23-25 (urging the Commission not to adopt a required list of unbundled elements more detailed than that adopted in Wyoming); *see also* Jones Intercable reply at 4-6 (the Commission should include in its national unbundling requirements a waiver procedure whereby incumbent LECs can demonstrate, in state mediations and arbitrations, their inability to meet a particular requirement in a particular situation); SBA comments at 14-15 (unbundling must go beyond three or four basic elements to maximize the ability of small competitors to fashion a competitive service offering); Hyperion comments at 7-8 (if we do not adopt national rules for unbundled elements small competitors could be hurt because they have fewer resources to negotiate agreements than incumbent LECs); TCA comments at 5-6 (rural incumbent LECs should only be required to offer four essential elements to requesting carriers because of differences between rural and urban areas, and in adopting unbundling requirements the Commission should ensure that rural LECs can meet their universal service obligations).

[489] AT&T comments at 3-12, reply at 9; Teleport comments at 5-10; DoJ comments at 8-15; Ad Hoc Telecommunications Users Committee comments at 17-21; Frontier comments at 14; TCC comments at 7-13; ACSI reply at 7 (if private negotiations were adequate there would be no need to create a statutory duty); *accord* PageNet reply at 5-6; Competition Policy Institute reply at 4-9; *see also* IDCMA reply at 8 (national unbundling requirements will facilitate the ability of new entrants to offer innovative services that would not be possible in the context of differing state requirements).

[490] *See, e.g.*, Continental comments at 16; Comcast comments at 20-22; DoJ comments at 8-15; Cable & Wireless comments at 17-19; TCC comments at 7-13; AT&T comments at 3-12; MCI comments at 4-6; Omnipoint comments at 17-18; ITIC comments at 2-5; Ind. Cable & Telecomm. Ass'n reply at 13; GST reply at 3-6; LDDS comments at 28; *accord, e.g.*, Ohio Commission comments at 31.

in network design,[491] diminish the likelihood of litigation over section 251(c)(3)'s requirements,[492] and provide the financial community with greater certainty as it assesses new entrants' business plans, thus enhancing the ability of new entrants to raise capital at affordable rates.[493]

235. Some commenters suggest that we interpret section 251(c)(3) in a way that maximizes unbundling by requiring incumbent LECs to provide all elements for which unbundling is technically feasible.[494] R. Koch argues that a detailed list of unbundled network elements will enable small entities to obtain the right combination of elements to allow them to offer specialized services.[495] Others suggest that we adopt national rules from which the states could deviate to address state-specific concerns. Parties contend that adopting such an approach (variously titled "safe harbors" or "preferred outcomes") would overcome the disincentives of incumbent LECs to provide network elements to competitors, and would allow states to pursue policies that promote competition more aggressively than the 1996 Act requires.[496] NTIA argues that minimum unbundling requirements would be underinclusive,

[491] *See, e.g.*, NCTA comments at 35-39; DoJ comments at 8-15; AT&T comments at 3-18; MCI comments at 4-6; MCI reply at 32; SCG comments at 1-4; Comcast comments at 6; MFS comments at 36; Cable & Wireless comments at 17-19; Continental comments at 16; Omnipoint comments at 17-18; American Mobile Telcomm. Ass'n comments at 1-5; Ohio Commission comments at 30-31; Nortel comments at 9-11; IDCMA reply at 6-7; Attorneys General reply at 6.

[492] *See, e.g.*, DoJ comments at 8-15; MCI comments at 4-6; AT&T comments at 3-12; *accord* IDCMA reply at 4-6.

[493] MCI comments at 4-6; Continental comments at 16; ITIC comments at 2-5.

[494] DoJ comments at 19-20; *accord* Nextel comments at 9; Ad Hoc Telecommunications Users Committee reply at 6; ACTA comments at 18-19 (arguing that the Commission should require incumbent LECs to unbundle all network elements with exceptions handled through a waiver procedure if the LEC can show that such unbundling is anticompetitive or otherwise not in the public interest); *see also* ASCI comments at 32 (incumbent LECs should be required to provide elements that are not required by the Commission or the States).

[495] R. Koch comments at 2.

[496] *See, e.g.*, Teleport comments at 5-10, 33-34; ALTS comments at 2-4; PacTel comments at 40-44 (the Commission should identify a list of unbundled network elements that are sufficient but not mandatory to comply with section 251); PacTel reply at 2; TRACER reply at 5-6; *see also* Texas Commission comments at 14; Florida Commission comments at 16-17 (the Commission should identify categories rather than specific elements); Pennsylvania Commission reply at 8-21 (the Commission should adopt minimum requirements only where necessary; such requirements should be broad enough to accommodate variations among states because of local technical, demographic and geographic differences); Colorado Commission comments at 25 (the Commission should adopt recommendations for required network elements, and allow the states to identify them and experiment); Rural Tel. Coalition reply at 5 (the Commission should provide guidance to the states rather than imposing detailed unbundling requirements, which would not be consistent with the deregulatory objectives of the 1996 Act); Competition Policy Institute reply at 9; Alaska Tel. Ass'n comments 2-3.

but detailed unbundling rules would provide insufficient flexibility to the states. NTIA thus recommends that the Commission require incumbent LECs to unbundle five different network elements, and mandate that the states require further unbundling consistent with local conditions.[497]

236. BellSouth, U S West, SNET and COMAV argue against the Commission's identification of a minimum list of required unbundled network elements. These parties contend that the provision of unbundled elements should be left entirely to parties in voluntary negotiations in order to accommodate state variations and to avoid requests for elements that competitors do not need, but nevertheless request in an effort to raise incumbent LECs' costs. These parties contend that national unbundling requirements would: dampen technological development because minimum requirements would be set at the lowest common denominator, retard the development of competition by complicating the regulatory review process, and curtail the incentives of incumbent LECs to develop new technologies and services.[498] Maine Commission, *et al.*, Colorado Independent Telephone Association, Home Telephone Company, the Rural Telephone Coalition, and Illinois Independent Telephone Association argue that national unbundling requirements would be unworkable because of technological, demographic and geographic variations among states. They contend that such rules would be particularly harmful to rural areas, and rural incumbent LECs, and that states must have flexibility to determine unbundling requirements that address state-specific concerns.[499]

237. GVNW and the Minnesota Independent Coalition argue that national unbundling requirements imposed on small incumbent LECs should differ from those imposed on large, urban incumbent LECs because of differences in networks and operational procedures.[500] The Rural Telephone Coalition contends that unbundling requirements for small and rural LECs should be limited "to those instances where it is technically feasible, specifically needed by a competitor and economically reasonable."[501]

---

[497] NTIA reply at 7-14.

[498] BellSouth comments at 16-19, 30-34; SNET comments at 18-24; U S West comments, Harris/Yao Report at 17; *see also* USTA reply at 10-13 (to encourage facilities-based competition the Commission should implement section 251(c)(3) in a way that provides parties with maximum flexibility); COMAV comments at 20 (because there is no clear definition of a network element, parties should be left to negotiate for what they want).

[499] Maine Commission, *et al.* comments at 2-10; Colorado Ind. Tel. Ass'n comments at 2; Home Tel. comments at 1-2; Illinois Ind. Tel. Ass'n comments at 1-2; *accord* Pennsylvania Commission reply at 15-16; Rural Tel. Coalition comments at 31-33.

[500] GVNW comments at 4-15; Minn. Ind. Coalition comments at 6-7.

[501] Rural Tel. Coalition comments at 31-33; *see also* GVNW comments at 21.

238. A broad range of parties support our tentative conclusion that states may impose additional unbundling requirements beyond those we specify as long as such requirements are consistent with the 1996 Act and our regulations.[502] A number of parties, including IXCs, state commissions, cable operators, CAPs, and new entrants, support our tentative conclusion that the Commission can establish additional or different unbundling requirements in the future as services, technology, and the needs of competing carriers evolve.[503] The Connecticut and Wyoming Commissions, in contrast, oppose this tentative conclusion. They argue that states should consider future unbundling requirements because they are more familiar with local networks and thus, will be able to address feasibility issues more efficiently.[504]

239. Yet another group of commenters, including incumbent LECs and state commissions, contend that future unbundling requirements should be determined by parties through voluntary negotiations.[505] Some argue that such negotiations should proceed under a Commission-mandated bona fide request (BFR) process.[506] USTA suggests that this process should include, for example, requirements regarding the timeliness of LEC responses to

---

[502] *See, e.g.*, TCC comments at 11-13, 34; NARUC comments at 32; Texas Commission comments at 15-16; Cable & Wireless comments at 17-19; MCI comments at 12-20; AT&T comments at 12-18; District of Columbia Commission comments at 21; ALTS comments at 24-26; USTA comments at 23; Colorado Commission comments at 24; Sprint comments at 21-22; ACSI comments at 32-34; CompTel comments at 32; Alabama Commission comments at 18; Oregon Commission comments at 24; LDDS comments at 28; GCI comments at 11; Municipal Utilities comments at 28; Ohio Consumers' Counsel comments at 17; Telecommunications Resellers Ass'n comments at 32; TIA comments at 9; TDS comments at 13-14; California Commission comments at 26; Illinois Commission comments at 35-36; Washington Commission comments at 19; Citizens Utilities comments at 12; Nortel comments at 10; Wyoming Commission comments at 23-25; *accord* Ohio Commission comments at 30-31 (it must be clear in whatever forum a BOC request for interexchange authority is reviewed that BOCs must comply with the state unbundling requirements).

[503] AT&T comments at 15-18; Texas Commission comments at 14-15; MCI comments at 12-20; Continental comments at 19; ALTS comments at 24-26; Pennsylvania Commission comments at 23; LDDS comments at 28; North Carolina Commission comments at 22; SBC comments at 4, 31; Oregon Commission comments at 2; Cable & Wireless comments at 17-19; Comcast comments at 19-21; *accord* CompTel comments at 40 (Commission should establish expedited procedures to permit carriers to request that the Commission identify additional elements); Sprint comments at 21-22 (future unbundling requirements can be identified both by the Commission and the states); NCTA comments at 37-38 (Commission should not leave to negotiations the identification of additional unbundled elements); TCC comments at 34 (unless the Commission states that it can adopt further unbundling requirements in the future, incumbent LECs will claim they need only provide the elements originally identified by the Commission).

[504] Connecticut Commission comments at 9; Wyoming Commission comments at 23-25.

[505] *See, e.g.*, Ameritech comments at 34-35; NYNEX comments at 61-64; Bell Atlantic comments at 15-20; ACSI comments at 33; USTA comments at ii; Ohio Commission comments at 32; GTE comments at 28 (impossible to determine in advance every element for which it is technically feasible to unbundle because such a determination must consider the service for which the element will be used and other issues); SBC reply at 18-19; New Hampshire Commission, *et al.* reply at 23.

[506] *See, e.g.*, Ameritech comments at 34-35; ASCI comments at 33; Ohio Commission comments at 32; SBC reply at 18-19.

requests, and commitments by requesting carriers to purchase requested elements and bear the cost of developmental efforts.[507] Bell Atlantic and SBC argue that a BFR process would clarify the duties of incumbent LECs and requesting carriers so that neither engage in gamesmanship,[508] prohibit sham requests intended to delay BOC entry into the in-region, interLATA market,[509] assist arbitrations by requiring the development of a record before the arbitrations commence,[510] and eliminate waste caused by regulatory requirements to unbundle "theoretical network components."[511]

240. A number of potential local competitors oppose identification of unbundled elements in the future by means of voluntary negotiations and a BFR process. In addition, they oppose the criteria offered by a number of incumbent LECs that would be used to identify future unbundling requirements in the context of the BFR process.[512] For example, AT&T argues that the factors in the BFR process proposed by USTA would impose anticompetitive reciprocity requirements and delays.[513] MCI and Sprint oppose USTA's proposal because it would require new entrants to commit to purchasing elements before they know the terms, including prices, under which the LEC will provide such elements.[514] MCI contends that, in a BFR process, LECs should be required to provide an up-to-date inventory of facilities with all information necessary to determine technical feasibility. Conversely, Sprint argues that it is reasonable to ask new entrants to provide technical information and projected demand quantities.[515]

---

[507] USTA comments at 14-16.

[508] Both Bell Atlantic and SBC assert that they have developed items for carriers that were never actually ordered. Bell Atlantic comments at 17-20; SBC reply at 18-19.

[509] Bell Atlantic comments at 17-20.

[510] Bell Atlantic comments at 17-20; Bell Atlantic reply at 7.

[511] Bell Atlantic comments at 17-20; Bell Atlantic reply at 7.

[512] CompTel comments at 41; AT&T reply at 16; MCI reply at 23-30; LDDS reply at 11-12; ALTS reply at 32-34; Sprint reply at 18; Hyperion reply at 5-6; *see also* CFA/CU reply at 22.

[513] AT&T reply at 16.

[514] MCI reply at 23-30; Sprint reply at 18.

[515] MCI reply at 23-30; Sprint reply at 18.

3. Discussion

241. We adopt our tentative conclusion and identify a minimum list of unbundled network elements that incumbent LECs must make available to new entrants upon request. We believe the procompetitive goals of section 251(c)(3) will best be achieved through the adoption of such a list. As discussed above,[516] we believe that negotiations and arbitrations will best promote efficient, rapid, and widespread new entry if we establish certain minimum national unbundling requirements. As the Department of Justice argues, there is "no basis in economic theory or in experience to expect incumbent monopolists to quickly negotiate arrangements to facilitate disciplining entry by would-be competitors, absent clear legal requirements to do so."[517] Ad Hoc Telecommunications Users Committee notes that "[h]istorically, the [incumbent LECs] have had strong incentives to resist, and have actively resisted, efforts to open their networks to users, competitors, or new technology-driven applications of network technology."[518]

242. National requirements for unbundled elements will allow new entrants, including small entities, seeking to enter local markets on a national or regional scale to take advantage of economies of scale in network design. If fifty states were to establish different unbundling requirements, new entrants, including small entities, could be denied the benefits of scale economies in obtaining access to unbundled elements. National requirements will also: reduce the number of issues states must consider in arbitrations, thereby facilitating the states' ability to conduct such proceedings; reduce the likelihood of litigation regarding the requirements of section 251(c)(3) and the costs associated with such litigation; and provide financial markets with greater certainty in assessing new entrants' business plans, thus enhancing the ability of new entrants, including small entities, to raise capital. In addition, to the extent the Commission assumes a state's arbitration authority under section 252(e)(5), national requirements for unbundled elements will help the Commission to conclude such proceedings expeditiously.[519]

243. We reject the alternative option of developing an exhaustive list of required unbundled elements, to which states could not add additional elements, on the grounds that

---

[516] *See supra*, Section V.B.

[517] DoJ comments at 8-15; *accord* Ad Hoc Telecommunications Users Committee comments at 17-21 (incumbent monopolists in the telecommunications industry have a long history of resisting the facilitation of competition, noting experiences with customer premises equipment (CPE) interconnection, local exchange access for long distance carriers, and the FCC's *Computer II* and *Computer III* proceedings).

[518] Ad Hoc Telecommunications Users Committee comments at 17; *see also infra*, Section VII.

[519] *See supra*, Sections II.A, II.B.

such a list would not necessarily accommodate changes in technology, and it would not provide states the flexibility they need to deal with local conditions.

244. We also reject the proposal advanced by several parties that we should adopt non-binding national guidelines for unbundled elements that states would not be required to enforce. The parties asserting that differences between incumbent LEC networks militate against the adoption of national standards provide few, if any, specific examples of what those differences are. In addition, they fail to articulate persuasively why those differences are significant enough to weigh against the adoption of national requirements.[520] Accordingly, and as previously discussed,[521] we conclude that any differences that may exist among states are not sufficiently great to overcome the procompetitive benefits that would result from establishing a minimum set of binding national rules.[522] Moreover, we believe the authority granted the states in section 252(e)(3), as well as our existing rules which set forth a process by which incumbent LECs can request a waiver of the requirements we adopt here, will provide the necessary flexibility in our rules to permit states and parties to accommodate any truly unique state conditions that might exist.[523] Accordingly, we adopt our tentative conclusion that states may impose additional unbundling requirements pursuant to section 252(e)(3), as long as such requirements are consistent with the 1996 Act and our regulations.

[520] The Florida Commission argues that we should not require incumbent LECs to offer a 4-wire ISDN loop as an unbundled element because some incumbents in Florida do not offer ISDN. Florida Commission comments at 16-17. Our rules accommodate the concern raised by the Florida Commission because they require requesting carriers to pay for the costs of obtaining access to unbundled network elements. Accordingly, if a requesting carrier seeks a 4-wire ISDN loop from an incumbent LEC that does not employ such an element, the requesting carrier will have to pay for it pursuant to our pricing rules. *See infra*, Section VII. Maine Commission *et. al.* argues generally that embedded networks have evolved over time and most network architectures are different. *See* Maine Commission *et. al.* comments at 2-4. They do not explain, however, why national rules could not accommodate such differences. PacTel argues that local loops may be made of copper or fiber optics, or they may be digital or analog, and thus, the Commission cannot determine the elements that should be unbundled without dictating network technologies. PacTel comments at 42-44. We do not believe that the adoption of national rules identifying a minimum list of unbundled network elements will lead to regulation determining network architectures. To the contrary, our rules will provide new entrants with the opportunity to obtain access to a number of different variants of a particular element, and thus they will facilitate the ability of the market to dictate network architectures. For example, in this order we identify a number of different types of local loops as network elements. *See infra*, Section V.J. Incumbent LECs will be required to provision such elements only if they are requested by new entrants. It is unlikely that new entrants will request and pay for elements unless they believe that there is likely to be some market demand for the services that can be provided over such elements.

[521] *See supra*, Sections II.A & II.B.

[522] *See* DoJ comments at 8-15 (the differences between states are not significant enough to "militate against" national requirements); AT&T comments at 14-18 (there are no conditions unique to one state, hence, all variations can be accommodated in national rules that include a waiver process for unusual conditions.)

[523] We further observed in the NPRM that under the voluntary negotiation paradigm set out in section 252, parties to such negotiations can agree to provide unbundled network elements that differ from those identified by the Commission. *See* NPRM at para. 78 (*citing* 47 U.S.C. § 252(a)).

This conclusion is consistent with the statement in section 252(e)(3) that "nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of an agreement."[524]

245. We find the arguments presented by parties opposing national rules for unbundled elements unpersuasive especially in light of the 1996 Act's strong procompetitive goals. For example, in light of the incumbent LECs' disincentives to negotiate with potential competitors, we believe national rules will promote competition by making the bargaining strength of potential competitors, including small entities, more equal. We are not persuaded that national rules will discourage incumbent LECs from developing new technologies and services; to the contrary, based on our experience in other telecommunications markets, we believe that competition will stimulate innovation by incumbent LECs. We also believe that any failure of incumbent LECs to develop new technologies or services would have a less significant adverse effect on competition in local exchange markets than a failure to adopt national rules. Nor is it likely that new entrants will seek unnecessary elements merely to raise incumbents' costs because such new entrants must pay the costs associated with unbundling. In addition, the pricing standard of section 252(d)(1)(B), which allows incumbent LECs to receive not only their costs but also a reasonable profit on the provision of unbundled elements, should further alleviate concerns regarding sham requests.[525]

246. We adopt our tentative conclusion that, in addition to identifying unbundled network elements that incumbent LECs must make available now, we have authority to identify additional, or perhaps different, unbundling requirements that would apply to incumbent LECs in the future. The rapid pace and ever changing nature of technological advancement in the telecommunications industry makes it essential that we retain the ability to revise our rules as circumstances change.[526] Otherwise, our rules might impede technological change and frustrate the 1996 Act's overriding goal of bringing the benefits of competition to consumers of local phone services. For the same reasons that we believe we should adopt national unbundling requirements, as discussed above,[527] we reject the proposal that future unbundling requirements should be determined solely by the parties to voluntary negotiations.

247. Finally, we have considered the economic impact of our rules in this section on small incumbent LECs. For example, we have considered the argument advanced by the

[524] 47 U.S.C. § 252(e)(3).

[525] *See infra*, Section VII.

[526] *See* 47 U.S.C. § 254(c)(1).

[527] *See also supra*, Sections II.A, II.B.

Rural Telephone Coalition that national unbundling requirements would be unworkable because of technological, demographic and geographic variations between states. We do not adopt the Rural Telephone Coalition's position, however, because we believe that the minimum list we adopt can be applied to a broad range of networks across geographic regions and any differences between incumbent LEC networks in different states are not sufficiently great to overcome the procompetitive benefits of a minimum list of required unbundled network elements. We have also considered the argument advanced by GVNW that unbundling requirements imposed on small incumbent LECs should differ from those imposed on large, urban incumbent LECs because of differences in networks and operational procedures. We reject GVNW's proposal for two reasons. First, some small incumbent LECs may not experience any problems complying with our unbundling rules. Second, we note that section 251(f) of the 1996 Act provides relief to certain small LECs from our regulations implementing section 251.

248. Although we have concluded in this proceeding that we can best achieve the procompetitive aims of the 1996 Act by adopting minimum national unbundling requirements for arbitrated agreements, the 1996 Act envisions that the states will administer those requirements through approval of negotiated agreements and arbitrations.[528] Through arbitrations and review of negotiated agreements the states will add to their significant expertise on issues relating to the provision of access to unbundled network elements. We encourage state commissions to take an active role in evaluating the success or difficulties in implementing any of our requirements. The Commission intends to draw on the expertise developed by the states when we review and revise our rules as necessary.

C. Network Elements

1. Background

249. Section 3(29) of the Communications Act defines the term "network element" to mean both "a facility or equipment used in the provision of a telecommunications service" and "features, functions, and capabilities that are provided by means of such facility or equipment."[529] Such features, functions, and capabilities include "subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service."[530] The Joint Explanatory Statement explains that "[t]he term 'network element' was included to describe

[528] 47 U.S.C. § 252.

[529] 47 U.S.C. § 153(29).

[530] *Id.*

the facilities, such as local loops, equipment, such as switching, and the features, functions, and capabilities that a local exchange carrier must provide for certain purposes under other sections of the conference agreement."[531]

250. In the NPRM, we noted that we could identify "network elements" in two ways. First, we could identify a single "network element," and then further subdivide it into additional "elements." Alternatively, we could provide that, once we identify a particular "network element," it cannot be further subdivided. In the NPRM, we asked for comment on these two approaches.[532]

251. We observed in the NPRM that the statutory definition of a "network element" draws a distinction between a "facility or equipment used in the provision of a telecommunications service," and the "service" itself.[533] We asked for comment on the meaning of this distinction in general, with respect to requirements for unbundling, and in connection with specific unbundled elements. We noted that the definition of a network element, *i.e.*, a facility, function, or capability, is not dependent on the particular types of services that are provided by means of the element (*e.g.*, interstate access, intrastate local exchange), and asked whether a carrier purchasing access to an element is obligated, pursuant to the definition, to provide all services typically carried or provided by that element.[534]

2. Comments

252. A number of parties, including potential local competitors and state commissions, support the adoption of a flexible method for identifying network elements. They argue that a flexible method is necessary to accommodate future changes in technology.[535] NYNEX, the Texas Public Utility Counsel, and GVNW contend that, to accommodate such changes, we

[531] Joint Explanatory Statement at 116.

[532] NPRM at para. 83.

[533] NPRM at para. 51, (*citing* 47 U.S.C. § 153(29)).

[534] NPRM at para. 84.

[535] District of Columbia Commission comments at 21-22; MFS comments at 36; Cable & Wireless comments at 17-19; Ericsson comments at 3; Alabama Commission comments at 19; ACSI comments at 30; Ohio Commission comments at 33; Florida Commission comments at 18; Hyperion comments at 18; GST comments at 16; LDDS comments at 29; Ohio Consumers' Counsel comments at 18; Nextel comments at 8; Time Warner comments at 44-45 (the Commission should identify elements in a way that gives parties maximum flexibility); *but see* Ad Hoc Telecommunications Users Committee comments at 15-16 (define elements narrowly to give maximum flexibility to offer innovative services).

should not define elements in rigid terms, or by specific technologies, but rather by general function.[536]

253. In contrast, PacTel argues that the Commission should not require the unbundling of elements beyond those noted in other parts of the statute, and thus we need not develop a flexible method for identifying network elements.[537] BellSouth contends that, while flexibility is preferable, parties should be able to decide "whatever level of granularity makes sense for them" in voluntary negotiations.[538]

254. A number of parties assert that we should define a network element by its functionality and capabilities, and not as separate services.[539] MCI asserts that elements can be used to provide a number of different services and thus are not service-specific. MCI further argues that elements should include all of their embedded features and functionalities so carriers can use them to provide both existing services that are already offered by incumbent LECs, and new ones that currently are not.[540] GTE contends that incumbent LECs use a wide variety of databases, functions and capabilities in their networks, but the definition of a network element is limited to those databases, functions and capabilities that are employed in the transmission, routing, or other provision of a telecommunications service. Thus, GTE would exclude from the definition features used in conjunction with, but not in the actual provision of, a telecommunications service as well as features used to provide information or other non-telecommunications services.[541]

255. AT&T asserts that vertical features (*i.e.*, custom calling or Custom Local Area Signaling Services ("CLASS")) are network elements because they constitute a function or a capability and are not by nature a jurisdictionally distinct service that can only be provided on

---

[536] NYNEX comments at 61-64; GVNW comments at 17-18; Texas Public Utility Counsel comments at 8-9.

[537] PacTel comments at 44-45; *see also* MECA comments at 28 (the Commission should not define network elements flexibly); COMAV comments at 20 (because a network element cannot be defined, the parties should decide what facilities they want during negotiations).

[538] BellSouth comments at 30-31.

[539] BellSouth comments at 30-31,62; MFS comments at 36-37, 65-66; Cable & Wireless comments at 26-27; MCI comments at 27-28; Lincoln Tel. comments at 7; GST comments at 6; Sprint comments at 22-23; Illinois Commission comments at 36-37; *see also* Intermedia comments at 12-13 (the Commission should not draw artificial distinctions between facilities and services as an unbundled element is not useful if it cannot support an end-to-end service).

[540] MCI comments at 27-28; *accord* Sprint comments at 22-23.

[541] GTE comments at 25-27; GTE reply at 16.

either an inter- or intra-state basis.[542] A number of incumbent LECs argue in opposition that vertical features are not physical elements of the incumbent LEC networks, but are retail services. They further argue that, if we allow new entrants to purchase such features as unbundled elements, we would nullify section 251(c)(4).[543] Ameritech also contends that vertical features are often priced significantly above cost, and for this reason carriers should not be allowed to obtain such services as unbundled elements.[544] Sprint claims that electronic interfaces (*e.g.*, administrative databases) used for the provision of unbundled elements can be considered network elements themselves.[545] A number of incumbent LECs, however, variously argue that such administrative databases, operator services, directory assistance, or electronic gateways are not network elements because new entrants do not need access to their features and functions to provide a telecommunications service. Moreover, these parties dispute claims that their features and functions are physical elements of the incumbents' networks. These parties characterize them as services. They further contend that it is not technically feasible or would be prohibitively expensive to provide access to such databases or electronic gateways and that requiring incumbent LECs to provision them as unbundled elements would both risk the security of those systems and reveal proprietary information.[546]

256. Commenters set forth a variety of views on the issue of whether the services or facility distinction requires carriers using an unbundled element to offer all services provided with that element. CompTel and MECA contend that the statute imposes such a requirement.[547] Sprint argues that a carrier purchasing an unbundled switch and loop must provide local exchange and exchange access services.[548] USTA and the Department of Justice contend that carriers must purchase exclusive access to an unbundled loop, and thus, must

---

[542] AT&T reply at 15-16.

[543] Ameritech reply at 24 n.38; PacTel reply at 25; Bell Atlantic reply at 6; USTA comments at 23-26; GTE comments at 25-26. Section 251(c)(4) provides that incumbent LECs have the duty "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers that are not telecommunications carriers." 47 U.S.C. § 251(c)(4). For a further discussion of the relationship between sections 251(c)(3) and 251(c)(4), *see infra*, Section V.H.

[544] Ameritech reply at 24 n.38.

[545] Sprint reply at 26.

[546] Ameritech reply at 19-20; U S West reply at 27; USTA reply at 17-18; NYNEX reply at 33-34 (while electronic gateways are not network elements, it is reasonable to request access to them); PacTel reply at 21-22; BellSouth reply at 24-30.

[547] Comptel comments at 24; MECA comments at 31.

[548] Sprint comments at 22-23.

provide all services carried over it.[549] The Department of Justice notes that this interpretation is required by practicality, and is consistent with industry practice at the time the 1996 Act was adopted.[550] The Department of Justice also notes that a local loop is a nontraffic sensitive facility, and thus it would be difficult to apportion the cost of such a facility among a number of different users.[551]

257. In contrast, a number of potential local competitors, as well as the Ohio and Oregon Commissions, contend that, according to the language of the 1996 Act, a carrier is not required to offer all services that an element makes possible. These parties variously argue that such a requirement would be unenforceable and anticompetitive, would stifle creativity in service offerings, and is contrary to the market-based policies inherent in the 1996 Act.[552]

3. Discussion

258. We adopt the concept of unbundled elements as physical facilities of the network, together with the features, functions, and capabilities associated with those facilities. Carriers requesting use of unbundled elements within the incumbent LEC's network seek in effect to purchase the right to obtain exclusive access to an entire facility, or use of some feature, function or capability of that element. For some elements, especially the loop, the requesting carrier will purchase exclusive access to the element for a specific period, such as on a monthly basis. Carriers seeking other elements, especially shared facilities such as common transport, are essentially purchasing access to a functionality of the incumbent's facilities on a minute-by-minute basis. This concept of network elements, as discussed *infra* at section V.G., does not alter the incumbent LEC's physical control or ability or duty to repair and maintain network elements.

259. We conclude that we should identify a particular facility or capability, for example, as a single network element, but allow ourselves and the states (where appropriate) the discretion to further identify, within that single facility or capability, additional required network elements. Thus, for example, in this proceeding, we identify the local loop as a

[549] USTA comments at 56-66; DoJ comments at 35-47.

[550] DoJ comments at 35-47.

[551] DoJ comments at 35-47.

[552] MCI comments at 27-28; ACTA comments at 17; LDDS comments at 30; MFS comments at 36-37,65-66; Cable & Wireless comments at 26-27; Frontier comments at 9; Ohio Commission comments at 33; Oregon Commission comments at 27; *accord* Citizens Utilities comments at 9.

single network element.[553] We also ask the states to evaluate, on a case-by-case basis, whether to require access to subloop elements, which can be facilities or capabilities within the local loop.[554] We agree with those commenters that argue that identifying a particular facility or capability as single network element, but allowing such elements to be further subdivided into additional elements, will allow our rules (as well as the states) to accommodate changes in technology, and thus better serve the interests of new entrants and incumbent LECs, and the procompetitive purposes of the 1996 Act.[555] We are not persuaded by PacTel's argument that it is unnecessary for our rules to permit the identification of additional elements, beyond those specifically referenced in parts of the 1996 Act, because our rules must conform to the definition of a network element, and they must accommodate changes in technology. Nor are we persuaded by BellSouth that identification of network elements should be left solely to the parties. We reject this approach for the same reasons that led us to adopt national unbundling requirements.[556] Finally, we agree with NYNEX and others that we should not identify elements in rigid terms, but rather by function.

260. We agree with MCI and MFS that the definition of the term network element includes physical facilities, such as a loop, switch, or other node, as well as logical features, functions, and capabilities that are provided by, for example, software located in a physical facility such as a switch.[557] We further agree with MCI that the embedded features and functions within a network element are part of the characteristics of that element and may not be removed from it. Accordingly, incumbent LECs must provide network elements along with all of their features and functions, so that new entrants may offer services that compete with those offered by incumbents as well as new services.

261. The only limitation that the statute imposes on the definition of a network element is that it must be "used in the provision of a telecommunications service."[558] Incumbent LECs provide telecommunications services not only through network facilities that serve as the basis for a particular service, or that accomplish physical delivery, but also through information (such as billing information) that enables incumbents to offer services on

[553] *See infra*, Section V.J.

[554] *Id.*

[555] *See, e.g.*, District of Columbia Commission comments at 21-22; MFS comments at 36.

[556] *See supra*, Sections II.A, II.B, V.B.

[557] MCI comments at 27-28; MFS comments at 36-37.

[558] 47 U.S.C. § 153(29).

a commercial basis to consumers. Our interpretation of the term "provision" finds support in the definition of the term "network element." That definition provides that the type of information that may constitute a feature or function includes information "used in the transmission, routing or other provision of a telecommunications service."[559] Since "transmission" and "routing" refer to physical delivery, the phrase "or other provision of a telecommunications service" goes beyond mere physical delivery.

262. We conclude that the definition of the term "network element" broadly includes all "facilit[ies] or equipment used in the provision of a telecommunications service," and all "features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service."[560] This definition thus includes, but is not limited to, transport trunks, call-related databases, software used in such databases, and all other unbundled elements that we identify in this proceeding.[561] The definition also includes information that incumbent LECs use to provide telecommunications functions commercially, such as information required for pre-ordering,[562] ordering, provisioning,[563] billing, and maintenance and repair services. This interpretation of the definition of the term "network element" will serve to guide both the Commission and the states in evaluating further unbundling requirements beyond those we identify in this proceeding.

263. We disagree with those incumbent LECs which argue that features that are sold directly to end users as retail services, such as vertical features, cannot be considered elements within incumbent LEC networks.[564] If we were to conclude that any functionality sold directly to end users as a service, such as call forwarding or caller ID, cannot be defined as a network element, then incumbent LECs could provide local service to end users by selling them unbundled loops and switch elements, and thereby entirely evade the unbundling

[559] *Id.*

[560] *Id.*

[561] *See infra*, V.J.

[562] *See infra*, Section V.J.5, for a definition of pre-ordering services.

[563] The term "provisioning" includes installation.

[564] *See infra*, Section V.J, discussing vertical features and noting that the Illinois Commission has rejected arguments that vertical features cannot be incorporated into network elements.

requirement in section 251(c)(3).[565] We are confident that Congress did not intend such a result. We further reject Ameritech's argument that we should not permit carriers to use unbundled elements to provide services that are priced above cost at retail. We agree with those parties that argue that competition will not develop if we find that supracompetitive pricing is protected by the 1996 Act.[566]

264. Moreover, we agree with those commenters that argue that network elements are defined by facilities or their functionalities or capabilities, and thus, cannot be defined as specific services. A single network element could be used to provide many different services. For example, a local loop can be used to provision inter- and intrastate exchange access services, as well as local exchange services. We conclude, consistent with the findings of the Ohio and Oregon Commissions, that the plain language of section 251(c)(3) does not obligate carriers purchasing access to network elements to provide all services that an unbundled element is capable of providing or that are typically offered over that element.[567] Section 251(c)(3) does not impose any service-related restrictions or requirements on requesting carriers in connection with the use of unbundled elements.

D. Access to Network Elements

1. Background

265. In the NPRM, we observed that section 251(c)(3) requires incumbent LECs to provide "access" to network elements "on an unbundled basis."[568] We interpreted these terms to mean that incumbent LECs must provide carriers with the functionality of a particular element, separate from the functionality of other elements, and must charge a separate fee for each element. We sought comment on this interpretation and any alternative interpretations.[569]

[565] *See, e.g.*, CompTel reply at 20-22.

[566] *See, e.g.*, DoJ reply at 23-31; CompTel reply at 13-22. For a discussion of the argument that allowing new entrants to purchase vertical features as unbundled elements would nullify section 251(c)(4), *see infra*, Section V.H.

[567] Ohio Commission comments at 33; Oregon Commission comments at 27.

[568] 47 U.S.C. § 251(c)(3).

[569] NPRM at para. 86.

2. Comments

266. A number of parties agree with our interpretation that the phrase "access to network elements on an unbundled basis" means that incumbent LECs must provide access to the functionality of different elements on a separate basis, and must charge separate fees.[570] In contrast, PacTel argues that the 1996 Act does not require the provision of an element's functionality, but merely requires incumbent LECs to provide elements in a way that allows carriers to combine them and offer a telecommunications service. PacTel nevertheless acknowledges that agreements will likely allow for the provision of an element's functionality.[571]

267. Bell Atlantic and USTA argue that "access" to unbundled elements can only be achieved by interconnecting, under the terms of section 251(c)(2), a requesting carrier's facilities to the facilities of the incumbent LEC at a particular point.[572]

3. Discussion

268. We conclude that we should adopt our proposed interpretation that the terms "access" to network elements "on an unbundled basis" mean that incumbent LECs must provide the facility or functionality of a particular element to requesting carriers, separate from the facility or functionality of other elements, for a separate fee. We further conclude that a telecommunications carrier purchasing access to an unbundled network facility is entitled to exclusive use of that facility for a period of time, or when purchasing access to a feature, function, or capability of a facility, a telecommunications carrier is entitled to use of that feature, function, or capability for a period of time. The specified period may vary depending on the terms of the agreement between the incumbent LEC and the requesting carrier. The ability of other carriers to obtain access to a network element for some period of time does not relieve the incumbent LEC of the duty to maintain, repair, or replace the unbundled network element.[573] We reject PacTel's interpretation of the terms quoted above

[570] BellSouth comments at 34; MFS comments at 41; Cable & Wireless comments at 26-27; MCI comments at 12-20; Ericsson comments at 4; District of Columbia Commission comments at 22; Nextel comments at 8; USTA comments at 26; Colorado Commission comments at 27; Pennsylvania Commission comments at 24-25; GTE comments at 27; Florida Commission comments at 19; GST comments at 19.

[571] PacTel comments at 44-47.

[572] Bell Atlantic comments at 13; USTA comments at 62-63; *see also* GTE comments at 74-79; Letter from Antoinette Cook Bush, Counsel for Ameritech, to William F. Caton, Secretary, FCC, July 10, 1996; *cf.* DoJ comments at 45 (the requirement in section 251(c)(2) that carriers must offer either local exchange or exchange access services does not apply to the carriers offering services using unbundled elements).

[573] We clarify that title to unbundled network elements will not shift to requesting carriers.

because it is inconsistent with our definition of the term network element (*i.e.*, an element includes all features and functions embedded in it). Moreover, to the extent that PacTel's argument suggests that the 1996 Act does not require unbundled elements to be provisioned in a way that would make them useful, we find that its statutory interpretation is inconsistent with the statute's goal of providing new entrants with realistic means of competing against incumbents.

269. We further conclude that "access" to an unbundled element refers to the means by which requesting carriers obtain an element's functionality in order to provide a telecommunications service. Just as section 251(c)(2) requires "interconnection . . . at any technically feasible point," section 251(c)(3) requires "access . . . at any technically feasible point."[574] We conclude, based on the terms of sections 251(c)(2), 251(c)(3), and 251(c)(6), that an incumbent LEC's duty to provide "access" constitutes a duty to provide a connection to a network element independent of any duty imposed by subsection (c)(2). Thus, such "access" must be provided under the rates, terms, and conditions that apply to unbundled elements.

270. Specifically, section 251(c)(6) provides that incumbent LECs must provide "physical collocation of equipment necessary for interconnection *or* access to unbundled network elements."[575] The use of the term "or" in this phrase means that interconnection is different from "access" to unbundled elements. The text of sections 251(c)(2) and (c)(3) leads to the same conclusion. Section 251(c)(2) requires that interconnection be provided for "the transmission and routing of telephone exchange service and exchange access."[576] Section 251(c)(3), in contrast, requires the provision of access to unbundled elements to allow requesting carriers to provide "a telecommunications service."[577] The term "telecommunications service" by definition includes a broader range of services than the terms "telephone exchange service and exchange access."[578] Subsection (c)(3), therefore, allows unbundled elements to be used for a broader range of services than subsection (c)(2) allows for interconnection. If we were to conclude that "access" to unbundled elements under subsection (c)(3) could only be achieved by means of interconnection under subsection (c)(2),

[574] 47 U.S.C. §§ 251(c)(2), 251(c)(3).

[575] 47 U.S.C. § 251(c)(6) (emphasis added).

[576] 47 U.S.C. § 251(c)(2).

[577] 47 U.S.C. § 251(c)(3).

[578] *See* 47 U.S.C. § 153(16),(46),(47).

we would be limiting, in effect, the uses to which unbundled elements may be put, contrary to the plain language of section 251(c)(3) and standard canons of statutory construction.[579]

E. Standards Necessary to Identify Unbundled Network Elements

1. Background

271. In the NPRM, we raised a number of issues concerning the meaning of technical feasibility in connection with unbundled elements.[580] We also sought comment on the extent to which the Commission should consider the standards set forth in section 251(d)(2) in identifying required unbundled elements, and on how we ought to interpret these standards.[581] Subsection (d)(2) provides that "(i)n determining what network elements should be made available for purposes of subsection (c)(3), the Commission shall consider, at a minimum" the following two standards, "whether (A) access to such network elements as are proprietary in nature is necessary; and (B) the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[582] We further asked about the relationship between the latter standard and the requirement in section 251(c)(3) that carriers be able to use unbundled elements to provide a telecommunications service.[583]

2. Comments

272. Commenters raised two issues in interpreting the standard relating to whether access to proprietary elements is necessary. The first issue relates to whether incumbent LECs are required to provide proprietary information contained in network elements (*e.g.*, Customer Premises Network Information contained in databases); and the second to whether incumbent LECs are required to provide network elements which are proprietary (*e.g.*, elements with proprietary protocols.) As to the first issue, Ameritech, SBC, BellSouth, PacTel, Texas Statewide Telephone Cooperative, Inc. and the Wyoming Commission argue that the Commission should protect proprietary information contained in incumbent LECs' networks.[584] BellSouth and PacTel further argue that we should prohibit access to elements containing proprietary information unless new entrants meet a heavy burden demonstrating need.[585]

273. As to the second issue, a few incumbent LECs argue generally that the Commission should require unbundling of proprietary network elements only under certain limited circumstances.[586] USTA argues that, if we do not grant incumbent LECs the ability to deny their competitors access to proprietary elements, we will stifle the incumbents' incentives to provide innovative services and thereby inhibit competition.[587] PacTel contends that we should not require unbundling of elements with proprietary protocols unless a new entrant demonstrates a heavy burden of need.[588] Ameritech and GTE assert that we should require unbundling of proprietary elements only when the failure to do so would prevent a carrier from offering a service.[589] GTE adds that, if an element is available from other sources, unbundling should not be mandated. Moreover, according to GTE, if incumbent LECs do make proprietary elements available, they should be compensated for the use of their intellectual property.[590] In contrast, the Consumer Federation of America asserts that, if we define proprietary elements broadly and require new entrants to demonstrate need before they may obtain them, we would significantly inhibit new entry.[591]

274. Most BOCs and GTE contend that the general obligation imposed by section 251(c)(3) is limited by section 251(d)(2)'s standard of whether the failure to provide access to network elements would impair the ability of carriers to offer a service. They argue that this standard requires incumbent LECs to provide unbundled elements only where the failure to do

---

[579] *See, e.g.*, DoJ comments at 35-47.

[580] NPRM at paras. 87-88. *See supra*, Section IV.D, for a discussion of these issues.

[581] NPRM at para. 88.

[582] 47 U.S.C. § 251(d)(2).

[583] NPRM at para. 90.

[584] Ameritech comments at 34; SBC comments at 36-37; Texas Statewide Telephone Cooperative, Inc. comments at 5-6; BellSouth comments at 35; PacTel comments at 40-44; Wyoming Commission at 24-26.

[585] BellSouth comments at 35; PacTel comments at 40-44.

[586] Ameritech comments at 34-35, reply at 11; BellSouth comments at 35; PacTel comments at 40-44; GTE comments at 30-31; GTE reply at 16; *see also* USTA comments at 27-28.

[587] USTA comments at 27-28.

[588] PacTel comments at 40-44, reply at 16-17; *see also* BellSouth comments at 35.

[589] Ameritech comments at 34-35; Ameritech reply at 11; GTE comments at 30-31; GTE reply at 16.

[590] GTE comments at 30-31.

[591] CFA/CU reply at 25; *see also* Letter from Bruce K. Cox, Government Affairs Director, AT&T to William F. Caton, Secretary, FCC, July 11, 1996 (AT&T July 11 *Ex Parte*).

so would prohibit a carrier from providing a service.[592] Commenters offer two different standards by which we may determine whether a carrier may require an incumbent LEC to provide an unbundled element in order for the carrier to offer a service. First, GTE, PacTel and BellSouth argue that unbundling is not required if a carrier can obtain, or provide itself, the requested element on reasonable terms and conditions.[593] The burden of meeting this standard, according to GTE, falls on the requesting carrier.[594] If a carrier fails to meet this standard, but continues to request an element, BellSouth claims, that carrier must meet a heavier burden.[595] Second, PacTel and Ameritech argue that, if a carrier can offer a service by purchasing the underlying service from the incumbent LEC and reselling it, pursuant to section 251(c)(4), the carrier is not impaired in its ability to offer the service. Thus, they argue, new entrants cannot use unbundled elements exclusively to offer the same services that new entrants can obtain from an incumbent LEC under the resale provision.[596]

275. The Department of Justice and Comptel reject the BOCs' argument that the general obligation imposed by section 251(c)(3) is limited by consideration of whether the failure to provide access to an element would impair a carrier's ability to offer a service. They argue that the term "impair" does not mean "prevent," and that we should interpret this standard to mean that a carrier's ability to provide a service is impaired if obtaining an element from a third party is more costly than obtaining that same element from the incumbent. They also dispute the incumbent LECs' argument that the "impair" language in this standard means that new entrants cannot exclusively use unbundled elements to provide the same or similar retail services that an incumbent offers. They argue that, if similarity is enough to prevent the use of unbundled elements, then section 251(c)(3) would be nullified. They further contend that, under the BOCs' theory, incumbents could prevent new entry through the use of unbundled elements by offering unbundled loops, switching, and other elements as retail services.[597] CompTel also argues that this standard refers back to the first standard in section 251(d)(2) and means that incumbents must provide proprietary elements

[592] BellSouth comments at 31-35; GTE comments at 30-31, GTE reply 16-17; Ameritech comments at 25-33; PacTel comments at 40-44, reply at 16-17; SBC comments at 36-37.

[593] GTE comments at 30-31; PacTel comments at 40-44, reply at 17 n.38; BellSouth comments at 35.

[594] GTE reply at 17.

[595] BellSouth comments at 35.

[596] BellSouth comments at 31-33; Ameritech comments at 25-31; *see infra,* Section V.H, for a further discussion of the relationship between sections 251(c)(3) and 251(c)(4).

[597] *See, e.g.,* DoJ comments at 48-51, reply at 23-31; CompTel reply at 13-22; *see also,* AT&T reply at 13-20.

only if the failure to do so would prevent a requesting carrier from offering a telecommunications service.[598]

276. AT&T argues that the plain language of section 251(c)(3) means that incumbent LECs must provide unbundled elements that new entrants request, and that the factors in section 251(d)(2) are minimum considerations and not threshold requirements.[599] BellSouth and SBC agree that the "at minimum" language in section 251(d)(2) means the Commission can consider other factors not enumerated in the statute in determining what elements incumbent LECs must offer to requesting carriers.[600] Similarly, several commenters suggest that, in determining which elements must be offered, we should consider a number of additional factors, including, for example, whether there is a demonstrable market demand for a particular element.[601]

3. Discussion

277. Sections 251(c)(3) and 251(d)(2) set forth standards the Commission must consider in identifying unbundled network elements that incumbent LECs must make available in connection with arbitrations before state commissions and BOC statements of generally available terms and conditions. These standards guide the unbundling requirements we issue today as well as any different or additional unbundling requirements we may issue in the future. Similarly, the states must follow our interpretation of these standards to the extent they impose additional unbundling requirements during arbitrations or subsequent rulemaking proceedings.

278. Section 251(c)(3) requires incumbent LECs to provide requesting carriers with "nondiscriminatory access to network elements on an unbundled basis at any technically feasible point."[602] We find that this clause imposes on an incumbent LEC the duty to provide all network elements for which it is technically feasible to provide access on an unbundled basis. Because section 251(d)(1) requires us to "establish regulations to implement the

[598] CompTel comments at 24-25; *see also* AT&T July 11 *Ex Parte*.

[599] *See* AT&T reply at 13-20.

[600] BellSouth comments at 17, 26; SBC comments at 18.

[601] *See, e.g.,* SBC comments at 25-37, 84-99; NYNEX comments at 61-64; Ameritech comments at 34; USTA comments at 23; *see also* Texas Public Utility Counsel comments at 9-11; CBT comments at 15; Nortel comments at 6; U S West comments at 45-47; ASCI comments at 32.

[602] 47 U.S.C. § 251(c)(3).

requirements of" section 251(c)(3), we conclude that we have authority to establish regulations that are coextensive with the duty section 251(c)(3) imposes on incumbent LECs.

279. Section 251(d)(2), however, sets forth standards that do not depend on technical feasibility. More specifically, section 251(d)(2) provides that, in identifying unbundled elements, the Commission shall "consider, at a minimum," whether access to proprietary elements is necessary (the "proprietary standard"), and whether requesting carriers' ability to provide services would be impaired if the desired elements were not provided by an incumbent LEC (the "impairment standard.") Thus, section 251(d)(2) gives us the authority to decline to require incumbent LECs to provide access to unbundled network elements at technically feasible points if, for example, we were to conclude that access to a particular proprietary element is not necessary. To give effect to both sections 251(c)(3) and 251(d)(2), we conclude that the proprietary and impairment standards in section 251(d)(2) grant us the authority to refrain from requiring incumbent LECs to provide all network elements for which it is technically feasible to provide access on an unbundled basis. The authority we derive from section 251(d)(2) is limited, however, by our interpretation of these standards, and this section, as set forth below.

280. We agree with BellSouth, SBC, and others that the plain import of the "at minimum" language in section 251(d)(2) requires us, in identifying unbundled network elements, to "consider" the standards enumerated there, as well as other standards we believe are consistent with the objectives of the 1996 Act. We conclude that the word "consider" means we must weigh the standards enumerated in section 251(d)(2) in evaluating whether to require the unbundling of a particular element.

281. We further conclude that, in evaluating whether to impose additional unbundling requirements during the arbitration process, states must apply our definition of technical feasibility, discussed above in section IV.D. A determination of technical feasibility would then create a presumption in favor of requiring an incumbent LEC to provide the element. If providing access to an unbundled element is technically feasible, a state must then consider the standards set forth in section 251(d)(2), as we interpret them below. Similarly, the Commission will apply this analysis where we must arbitrate specific unbundling issues, under section 252(e)(5), and in future rulemaking proceedings that may consider additional or possibly different unbundling requirements.

282. Section 251(d)(2)(A) requires the Commission and the states to consider whether access to proprietary elements is "necessary." "Necessary" means, in this context, that an element is a prerequisite for competition. We believe that, in some instances, it will be "necessary" for new entrants to obtain access to proprietary elements (*e.g.*, elements with proprietary protocols or elements containing proprietary information), because without such

elements, their ability to compete would be significantly impaired or thwarted.[603] Thus, as an initial matter, we decline to adopt a general rule, as suggested by some incumbents, that would prohibit access to such elements, or make access available only upon a carrier demonstrating a heavy burden of need. We acknowledge that prohibiting incumbents from refusing access to proprietary elements could reduce their incentives to offer innovative services. We are not persuaded, however, that this is a sufficient reason to prohibit generally the unbundling of proprietary elements, because the threat to competition from any such prohibition would far exceed any costs to consumers resulting from reduced innovation by the incumbent LEC.[604] Moreover, the procompetitive effects of our conclusion generally will stimulate innovation in the market, offsetting any hypothetical reduction in innovation by the incumbent LECs.

283. We further conclude that, to the extent new entrants seek additional elements beyond those we identify herein, section 251(d)(2)(A) allows the Commission and the states to require the unbundling of such elements unless the incumbent can prove to a state commission that: (1) the element is proprietary, or contains proprietary information that will be revealed if the element is provided on an unbundled basis; and (2) a new entrant could offer the same proposed telecommunications service through the use of other, nonproprietary unbundled elements within the incumbent's network. We believe this interpretation of section 251(d)(2)(A) will best advance the procompetitive purposes of the 1996 Act. It allows new entrants to obtain proprietary elements from incumbent LECs where they are necessary to offer a telecommunications service, and, at the same time, it gives incumbents the opportunity to argue, before the states or the Commission, against unbundling proprietary elements where a new entrant could offer the same service using other unbundled elements in the incumbent's network. We decline to adopt the interpretation of section 251(d)(2)(A) advanced by some incumbents that incumbent LECs need not provide proprietary elements if requesting carriers can obtain the requested proprietary element from a source other than the incumbent. Requiring new entrants to duplicate unnecessarily even a part of the incumbent's network could generate delay and higher costs for new entrants, and thereby impede entry by competing local providers and delay competition, contrary to the goals of the 1996 Act.

284. We further conclude that, to the extent new entrants do not need access to all the proprietary information contained within an element in order to provide a telecommunications service, the Commission and the states may take action to protect the proprietary information.

---

[603] As noted *supra*, Section V.E.2, a number of commenters argue that section 251(d)(2)(A) requires us to protect proprietary information, such as CPNI information, contained in network elements. We intend to treat issues regarding CPNI in our rulemaking proceeding on CPNI information. *Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information*, CC Docket No. 96-115, Notice of Proposed Rulemaking, FCC 96-221 (rel. May 17, 1996).

[604] In this proceeding, for example, we are requiring incumbent LECs to provide the local switching element which includes vertical features that some carriers contend are proprietary. *See infra*, Section V.J.

For example, to provide a telecommunications service, a new entrant might need access to information about a particular customer that is in an incumbent LEC database. The database to which the new entrant requires access, however, may contain proprietary information about all of the incumbent LECs' customers. In this circumstance, the new entrant should not have access to proprietary information about the incumbent LEC's other customers where it is not necessary to provide service to the new entrant's particular customer. Accordingly, we believe the Commission and the states have the authority to protect the confidentiality of proprietary information in an unbundled network element, such as a database, where that information is not necessary to enable a new entrant to offer a telecommunications service to its particular customer.

285. Section 251(d)(2)(B) requires us to consider whether the failure to provide access to an element would "impair" the ability of a new entrant to provide a service it seeks to offer. The term "impair" means "to make or cause to become worse; diminish in value."[605] We believe, generally, that an entrant's ability to offer a telecommunications service is "diminished in value" if the quality of the service the entrant can offer, absent access to the requested element, declines and/or the cost of providing the service rises. We believe we must consider this standard by evaluating whether a carrier could offer a service using other unbundled elements within an incumbent LEC's network. Accordingly, we interpret the "impairment" standard as requiring the Commission and the states, when evaluating unbundling requirements beyond those identified in our minimum list, to consider whether the failure of an incumbent to provide access to a network element would decrease the quality, or increase the financial or administrative cost of the service a requesting carrier seeks to offer, compared with providing that service over other unbundled elements in the incumbent LEC's network.

286. We decline to adopt the interpretation of the "impairment" standard advanced by most BOCs and GTE. Under their interpretation, incumbent LECs must provide unbundled elements only when the failure to do so would prevent a carrier from offering a service. We also reject the related interpretations that carriers are not impaired in their ability to provide a service if they can obtain elements from another source, or if they can provide the proposed service by purchasing the service at wholesale rates from a LEC. In general, and as discussed above, section 251(c)(3) imposes on incumbent LECs the obligation to offer on an unbundled basis all network elements for which it is technically feasible to provide access. We believe the plain language of section 251(d)(2), and the standards articulated there, give us the discretion to limit the general obligation imposed by subsection 251(c)(3), but they do not require us to do so. The standards set forth in section 251(d)(2) are minimum considerations that the Commission shall take into account in evaluating unbundling requirements. Accordingly, we conclude that the statute does not require us to interpret the "impairment"

[605] *See* Random House College Dictionary 665 (rev. ed. 1984).

standard in a way that would significantly diminish the obligation imposed by section 251(c)(3).

287. The interpretation advanced by most of the BOCs and GTE, described above, means that, if a requesting carrier could obtain an element from a source other than the incumbent, then the incumbent need not provide the element. We agree with the reasoning advanced by some of the commenters that this interpretation would nullify section 251(c)(3) because, in theory, any new entrant could provide all of the elements in the incumbents' networks. Congress made it possible for competitors to enter local markets through the purchase of unbundled elements because it recognized that duplication of an incumbent's network could delay entry, and could be inefficient and unnecessary.[606] The interpretation proffered by the BOCs and GTE would inhibit new entry and thus restrict the potential for meaningful competition, which would undermine the procompetitive goals of the 1996 Act. As a practical matter, if it is more efficient and less costly for new entrants to obtain network elements from a source other than an incumbent LEC, new entrants will likely pursue the more efficient and less costly approach. Additionally, as discussed above at section IV.C, we believe that allowing incumbent LECs to deny access to unbundled elements on the grounds that an element is equivalent to a service available at resale would lead to impractical results, because incumbents could completely avoid section 251(c)(3)'s unbundling obligations by offering unbundled elements to end users as retail services.[607]

288. Finally, we decline at this time to adopt any of the additional criteria proposed by commenters. We conclude that none of the additional factors suggested by commenters enhances our ability to identify unbundled network elements consistent with the procompetitive goals of the 1996 Act.[608] These additional considerations would limit unbundling requirements or make it administratively more difficult for new entrants to obtain additional unbundled elements beyond those identified in our minimum list of required elements. For example, we believe that the proposal that new entrants must provide detailed estimates regarding projected market demand is not necessary for incumbent LECs to efficiently plan for network growth.

[606] *See* LDDS comments at 37, reply at 14-15.

[607] *See infra*, Section V.H, for a further discussion on the relationship between sections 251(c)(3) and 251(c)(4).

[608] *See, e.g.*, Texas Public Utility Counsel comments at 9-11; Cincinnati Bell comments at 15; Nortel comments at 6 (the diversion of research and development efforts to facilities that new entrants do not really want will stifle innovation); SBC comments at 25-37, 84-99.

F. Provision of a Telecommunications Service Using Unbundled Network Elements

1. Background

289. Section 251(c)(3) provides that an incumbent LEC must provide access to "unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide" a telecommunications service.[609] In the NPRM, we sought comment on the meaning of this requirement.

2. Comments

290. The Illinois Commission and Texas Public Utility Counsel, as well as a number of potential local competitors, argue that incumbent LECs cannot limit the nature of requests for required elements, restrict the sale of those elements or the manner in which carriers use them,[610] impose requirements on the use of unbundled elements, or require the purchase of elements that carriers do not need.[611] The Texas Public Utility Counsel contends that carriers may combine unbundled elements with any technically-compatible equipment.[612] AT&T argues that incumbent LECs should be prohibited from separating elements that are ordered in combination, or from varying the definition of an unbundled element based on the services a carrier seeks to offer (absent the consent of the requesting carrier). AT&T and Comptel also argue that, in order to enable new entrants to offer competing services, incumbent LECs must perform the functions necessary to combine elements, and they must do so in any technically feasible manner requested by a new entrant.[613] According to Comptel, incumbent LECs must provide the operational and back office systems necessary for requesting carriers to purchase and combine network elements, otherwise the new entrants' ability to compete will be

[609] 47 U.S.C. § 251(c)(3).

[610] Illinois Commission comments at 36-38; CompTel reply at 21; Cable & Wireless reply at 20; LDDS comments at 40 (the statute grants carriers the right to use unbundled elements to offer any telecommunications service); *accord* GCI reply at 11.

[611] LDDS comments at 40; AT&T comments at 27; Cable & Wireless reply at 20; Texas Public Utility Counsel comments at 8-9; *see also* NCTA comments at 40-41 (new entrants must have access to elements that are necessary to provide a telecommunications service).

[612] Texas Public Utility Counsel comments at 8-9.

[613] AT&T comments at 27; CompTel reply at 23-24; *see also* MCI comments at 23.

impaired.[614] Sprint contends that this provision requires incumbents to offer different facilities and services in connection with a particular element, depending on the service a requesting carrier seeks to offer.[615] The Florida Commission argues, however, that, if a new entrant needs a particular variation of an element to offer a service, that element should be treated as distinct. This means, for example, that, if a requesting carrier seeks a local loop with a specific kind of conditioning, that loop should be treated as a distinct element from loops with other kinds of conditioning.[616]

291. NYNEX contends that incumbent LECs are not obligated to connect unbundled elements either to each other or to new entrants' facilities, and that the text of section 251(c)(3) requires requesting carriers to do the combining.[617] BellSouth argues that section 251(c)(3) requires requesting carriers to identify network elements with sufficient specificity so that their characteristics and appropriate uses can be defined. BellSouth contends that section 251(c)(3) prohibits carriers from requesting elements to provide cable or information services.[618]

3. Discussion

292. Under section 251(c)(3), incumbent LECs must provide access to "unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide" a telecommunications service.[619] We agree with the Illinois Commission, the Texas Public Utility Counsel, and others that this language bars incumbent LECs from imposing limitations, restrictions, or requirements on requests for, or the sale or use of, unbundled elements that would impair the ability of requesting carriers to offer telecommunications services in the manner they intend. For example, incumbent LECs may not restrict the types of telecommunications services requesting carriers may offer through unbundled elements, nor may they restrict requesting carriers from combining elements with

[614] CompTel comments at 38. Back office systems include the administrative means by which incumbent LECs commercially provision telecommunications services to consumers. Thus, they include the means by which incumbent LECs accept orders for services, respond to requests for repairs, etc.

[615] Sprint comments at 30.

[616] Florida Commission comments at 22.

[617] NYNEX reply at 19.

[618] BellSouth comments at 36; *see also* PacTel reply at 16-17.

[619] 47 U.S.C. § 251(c)(3).

any technically compatible equipment the requesting carriers own. We also conclude that section 251(c)(3) requires incumbent LECs to provide requesting carriers with all of the functionalities of a particular element, so that requesting carriers can provide any telecommunications services that can be offered by means of the element. We believe this interpretation provides new entrants with the requisite ability to use unbundled elements flexibly to respond to market forces, and thus is consistent with the procompetitive goals of the 1996 Act.

293. We agree with AT&T and Comptel that the quoted text in section 251(c)(3) bars incumbent LECs from separating elements that are ordered in combination, unless a requesting carrier specifically asks that such elements be separated. We also conclude that the quoted text requires incumbent LECs, if necessary, to perform the functions necessary to combine requested elements in any technically feasible manner either with other elements from the incumbent's network, or with elements possessed by new entrants, subject to the technical feasibility restrictions discussed below. We adopt these conclusions for two reasons. First, in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent. If we adopted NYNEX's proposal, we believe requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets. We therefore reject NYNEX's contention that the statute requires requesting carriers, rather than incumbents, to combine elements. We do not believe it is possible that Congress, having created the opportunity to enter local telephone markets through the use of unbundled elements, intended to undermine that opportunity by imposing technical obligations on requesting carriers that they might not be able to readily meet.

294. Second, given the practical difficulties of requiring requesting carriers to combine elements that are part of the incumbent LEC's network, we conclude that section 251(c)(3) should be read to require incumbent LECs to combine elements requested by carriers. More specifically, section 251(c)(3) provides that incumbent LECs must provide unbundled elements "in a manner that allows requesting carriers to combine them" to provide a telecommunications service. We believe this phrase means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service. The phrase "allows requesting carriers to combine them," does not impose the obligation of physically combining elements exclusively on requesting carriers. Rather, it permits a requesting carrier to combine the elements if the carrier is reasonably able to do so. If the carrier is unable to combine the elements, the incumbent must do so.[620]

[620] In this context, we conclude that the term "combine" means connecting two or more unbundled network elements in a manner that would allow a requesting carrier to offer the telecommunications service it seeks to offer.

295. Our conclusion that incumbent LECs must combine unbundled elements when so requested is consistent with the method we have adopted to identify unbundled network elements. Under our method, incumbents must provide, as a single, combined element, facilities that could comprise more than one element. This means, for example, that, if the states require incumbent LECs to provision subloop elements, incumbent LECs must still provision a local loop as a single, combined element when so requested, because we identify local loops as a single element in this proceeding.[621]

296. We decline to adopt the view proffered by some parties that incumbents must combine network elements in any technically feasible manner requested. This proposal necessarily means that carriers could request incumbent LECs to combine elements that are not ordinarily combined in the incumbent's network. We are concerned that, in some instances, this could potentially affect the reliability and security of the incumbent's network, and the ability of other carriers to obtain interconnection, or request and use unbundled elements. Accordingly, incumbent LECs are required to perform the functions necessary to combine those elements that are ordinarily combined within their network, in the manner in which they are typically combined. Incumbent LECs are also required to perform the functions necessary to combine elements, even if they are not ordinarily combined in that manner, or they are not ordinarily combined in the incumbent's network, provided that such combination is technically feasible,[622] and such combination would not undermine the ability of other carriers to access unbundled elements or interconnect with the incumbent LEC's network. Incumbent LECs must prove to state commissions that a request to combine particular elements in a particular manner is not technically feasible, or that the request would undermine the ability of other carriers to access unbundled elements and interconnect because they have the information to support such a claim.

297. We agree with Sprint and the Florida Commission, respectively, that in some cases incumbent LECs may be required to provision a particular element in different ways, depending on the service a requesting carrier seeks to offer; and, in other instances, where a new entrant needs a particular variant of an element to offer a service, that element should be treated as distinct from other variants of the element. This means, for example, that we will treat local loops with a particular type of conditioning[623] as distinct elements that are different

[621] *See infra*, Section V.J.

[622] As discussed in Section IV, effects on network reliability and security are factors to be considered in determining technical feasibility.

[623] For an explanation of what conditioning of a local loop means *see infra*, Section V.J.1.

from loops with other types of conditioning.[624] As discussed below, we agree with CompTel that incumbent LECs must provide the operational and support systems necessary for requesting carriers to purchase and combine network elements. Incumbent LECs use these systems to provide services to their own end users, and new entrants similarly must have access to them to provide telecommunications services using unbundled elements.[625] Finally, we agree with BellSouth that requesting carriers must specify to incumbent LECs the network elements they seek before they can obtain such elements on an unbundled basis. We do not believe, however, that it will always be possible for new entrants to do this either before negotiations (or arbitrations) begin, or before they end, because new entrants will likely lack knowledge about the facilities and capabilities of a particular incumbent LEC's network. We further believe that incumbent LECs must work with new entrants to identify the elements the new entrants will need to offer a particular service in the manner the new entrants intend.

G. Nondiscriminatory Access to Unbundled Network Elements and Just, Reasonable and Nondiscriminatory Terms and Conditions for the Provision of Unbundled Network Elements

1. Background

298. Section 251(c)(3) requires incumbent LECs to provide requesting carriers "nondiscriminatory access to network elements on an unbundled basis . . . on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[626] In the NPRM, we sought comment on whether we should adopt minimum national requirements governing the terms and conditions for the provision of unbundled network elements. We further asked what rules could ensure that the terms and conditions for access to unbundled network elements are just, reasonable and nondiscriminatory, and how we should enforce such rules. In particular, we sought comment on whether we should adopt uniform national rules governing provisioning, service, maintenance, technical standards and nondiscrimination safeguards in connection with the provision of unbundled network elements. We also asked whether we should consider any of the terms and conditions applicable to the provision of access to unbundled elements in evaluating BOC applications to provide in-region interLATA services under section 271(b).[627]

2. Comments

[624] Florida Commission comments at 22.

[625] Incumbent LEC back-office systems are discussed in Section V.J.

[626] 47 U.S.C. § 251(c)(3).

[627] NPRM at paras. 79, 89.

299. The Florida, Illinois and Washington Commissions, as well as a number of potential competitors, argue that we should adopt national standards governing the terms and conditions for the provision of unbundled elements to ensure that new entrants obtain nondiscriminatory access to elements. These parties contend that incumbent LECs have the incentive and ability to delay the provisioning of unbundled elements, to provide lower quality services to new entrants, and engage in other anticompetitive tactics. They further argue that it would be a tremendous barrier to entry if new entrants had to negotiate the terms and conditions for the provision of unbundled elements on a state by state basis, especially in light of the incumbent LECs' superior bargaining power. Accordingly, they argue that we should establish requirements mandating nondiscriminatory performance for ordering, installation, provisioning, maintenance, repair and billing.[628] Cable & Wireless argues that access to unbundled network elements on a nondiscriminatory basis will assist small carriers in entering local exchange markets because small carriers cannot afford the capital necessary to build competing infrastructure.[629]

300. The parties arguing for national standards governing the terms and conditions for the provision of unbundled elements disagree, however, on the types of requirements we should establish. Teleport and Intermedia Communications argue that incumbent LECs should be required to provide installation, service and maintenance for new entrants pursuant to the same standards they do for themselves.[630] NCTA, MCI, and Cable & Wireless argue that we should adopt specific standards, including time limits, for implementation of requests for unbundled elements.[631] MCI, AT&T, Frontier and the Washington and Texas Commissions further argue that incumbents should be required to provide access to unbundled elements that

[628] MFS comments at 16-17, 41; AT&T comments at 33-39; AT&T reply at 21-22; TCC comments at 54-60; Cable & Wireless comments at 36-37; MCI comments at 20-27; Ericsson comments at 3; Continental comments at 19; Comcast comments at 24-25; Intermedia comments at 3-13; Florida Commission comments at 21; Illinois Commission comments at 40; Washington Commission comments at 21-22; Sprint comments at 17-19; GST comments at 17; Teleport reply at 26-29; Nextel comments at 9-10; NCTA comments at 44-46; Colorado Commission comments at 27 (some general terms and conditions would be useful); Texas Commission comments at 15-16.

[629] Cable & Wireless comments at 23; *see also* SBA comments at 14-15 (the Commission should establish terms and conditions for the provision of unbundled elements, for otherwise, the provision of unbundled elements to smaller competitors would be rendered useless).

[630] Teleport comments at 25, 33-34, reply at 26-29; Intermedia comments at 3-13.

[631] NCTA comments at 44-46; MCI comments at 24-30; Cable & Wireless comments at 36-37; *see also* Intermedia comments at 3-6.

is equal in quality to what the incumbents provide themselves.[632] PageNet argues that the "equal-in-quality" standard does not mean that treatment should be identical where different technology is used, but that the quality should be the same.[633] Time Warner and Continental argue that we should subject incumbents to reasonable provisioning standards.[634] The District of Columbia Commission argues that we should adopt a general rule that the incumbent must offer the same services under the same terms and conditions to all similarly situated customers.[635] Finally, Lincoln Tel. argues that the Commission should adopt the terms and conditions established in our Expanded Interconnection and Open Network Architecture proceedings.[636]

301. A number of incumbents, including Bell Atlantic, SBC, GVNW and NYNEX, contend that we should not set specific rules, including time limits, for installation, service, maintenance and repair because incumbent LECs have different operational and administrative systems, and are subject to different state standards.[637] GVNW further notes that specific intervals would impose an uneconomic burden on rural LECs because it would force them to purchase excess capacity in advance.[638] The Washington and Florida Commissions, as well as SBC, GVNW, NYNEX, and AT&T, argue that we should adopt a general nondiscrimination standard and require incumbent LECs to provide network elements to new entrants according to the same installation, service, and maintenance intervals that apply to LEC customers and services. The Florida Commission observes that state requirements vary by state, and therefore states are in the best position to evaluate disputes relating to installation, service and

[632] MCI comments at 23; AT&T comments at 33-39 (the Commission has imposed similar requirements in other instances where the BOCs provide competitive services that rely on monopoly inputs controlled by the BOCs); Texas Commission comments at 15-16; Washington Commission comments at 21; Frontier comments at 18; *accord* MFS comments at 17, 41; *see also* ACSI comments at 51; Ohio commission comments at 31.

[633] PageNet comments at 6-9.

[634] Time Warner comments at 44-45; Continental comments at 20.

[635] District of Columbia Commission comments at 19-22.

[636] Lincoln Tel. comments at 9.

[637] Bell Atlantic comments at 31; SBC comments at 37-38; GVNW comments at 17; NYNEX reply at 32-33; *see also* Colorado Commission comments at 24-27 (certain technical standards may not be economically reasonable in all areas because of differences in technology, demography and geography).

[638] GVNW comments at 17.

maintenance intervals.[639] NYNEX explains that implementation of such a general standard will vary based on technology, service offering, and geographic area, and therefore states and negotiating parties are in the best position to determine specific implementation responsibilities.[640] TCC argues that we should adopt a general standard prohibiting incumbents from favoring their own retail operations and that consumers should not be able to perceive a difference between services provided by incumbents and those provided by new entrants.[641] Bell Atlantic contends that, while we should adopt a general nondiscrimination standard, this standard should not incorporate the standards that apply to LEC customers and services because many unbundled elements are new services with which incumbent LECs have no experience.[642] The Pennsylvania Commission argues that the terms and conditions adopted herein should accommodate local variations.[643]

302. A number of potential competitors argue that, to achieve nondiscriminatory provision of unbundled elements, incumbent LECs must be required to provide pre-ordering, ordering, provisioning, billing, and maintenance and repair, and other services on a "real time" basis, which can only be done through the use of electronic ordering interfaces.[644] CompTel argues that incumbents provide these types of services to themselves by automated means and therefore they should be available to competing providers through automation.[645] AT&T contends that manual interfaces for the provision of unbundled elements would cause overwhelming delays that would inhibit the ability of new entrants to compete.[646] AT&T further argues that we should establish national standards for gateways that would interface with incumbent LEC electronic ordering systems. According to AT&T, the Commission

[639] Washington Commission comments at 21-22; Florida Commission comments at 21; SBC comments at 37-38; AT&T comments at 33-39; AT&T reply at 21-22; NYNEX reply at 32-33; *accord* TCC comments at 54-60; Intermedia comments at 3-13.

[640] NYNEX reply at 32-33.

[641] TCC comments at 54-60.

[642] Bell Atlantic comments at 31.

[643] Pennsylvania Commission comments at 25.

[644] Sprint comments at 17-22; Teleport reply at 26-29; AT&T comments at 33-39; AT&T reply at 21-22; TCC comments at 54-60; MCI comments at 23. *See infra*, Section V.J.5, summarizing the Electronic Communications Implementation Committee's definition of an electronic interface.

[645] CompTel reply at 23-24.

[646] AT&T comments at 33-39, reply at 21-22.

should oversee the development of such gateways and incumbent LECs should be required to provide electronic ordering systems with the same level of quality that they provide in such systems for themselves.[647] AT&T, MCI, and Sprint argue that we should establish deadlines for the development of electronic interface systems, and a deadline for implementation of such systems.[648] TCC argues that incumbents should not delay provision of unbundled elements until automated interfaces are developed.[649] Lincoln Tel. contends, however, that we should not require small and medium size incumbent LECs to provide electronic ordering interfaces.[650]

303. Some potential competitors argue that we should impose additional terms and conditions for the provision of unbundled elements, including all test and turn-up procedures, nondiscriminatory access to incumbent LEC databases, around-the-clock provisioning support, and processes that would make it as easy and transparent for a customer to switch local carriers as it currently is to switch long distance carriers. These parties argue that we should require incumbents to continue to participate in cooperative industry practices, such as the Centralized Message Distribution System, and that new entrants should have access to such systems.[651] Sprint and NCTA contend that, because incumbent LECs can obtain access to a new entrant's CPNI, through access to signaling and databases, we should prohibit incumbent LECs from using a new entrant's proprietary information for marketing purposes.[652] MFS argues that we should set minimum technical standards in connection with the provision of unbundled elements, and thus we should require incumbent LECs to offer new entrants any type of loop facilities (*e.g.*, loop upgrades and conditioning) and transmission capabilities available within its network.[653] MCI contends we should adopt national technical standards in connection with the means to combine elements and access to information and that such technical standards should meet Bellcore and ANSI requirements. MCI further contends that,

[647] AT&T comments at 33-39; *accord* TCC comments at 54-60.

[648] AT&T comments at 33-39; Sprint comments at 17-22 (the Commission should direct the industry to develop standards for electronic bonding within 12 months, and should require incumbents to implement these standards within 12 months); MCI comments at 20-27; MCI reply at 28-30.

[649] TCC comments at 54-60.

[650] Lincoln Tel. comments at 9.

[651] *See, e.g.*, MCI comments at 23; AT&T comments at 33-39; Continental comments at 23.

[652] Sprint comments at 17-22; NCTA comments at 43.

[653] MFS reply at 18-19.

to overcome incumbent LEC incentives to engage in dilatory tactics, the Commission should require incumbent LECs to implement the terms and conditions for the provision of unbundled elements within six months after the end of negotiations or arbitrations. MCI contends that this requirement will hasten the development of the technical standards and operational support systems that are necessary to provide unbundled elements in a nondiscriminatory manner.[654] AT&T argues that the terms and conditions for pre-ordering, ordering, provisioning, billing, and maintenance and repair should be the same under sections 251(c)(3) and 251(c)(4).[655]

304. PacTel and USTA argue that we should not establish national standards for installation, service, and maintenance and repair in connection with the provision of unbundled elements. PacTel contends that we should merely establish guidelines. USTA argues that the 1996 Act does not authorize the Commission to establish such standards, and the advantages of rules for the provision of unbundled elements are more than offset by the impingement on voluntary negotiations.[656] USTA and the California Commission further argue that we should not adopt technical standards to insure interoperability between networks because this function is performed by standards bodies, and the differences in operational and administrative systems between LEC networks result in different provisioning and service intervals. They further argue that any requirements on technical standards would hinder efficiency.[657] PacTel argues that there is very little opportunity for discrimination against competing providers because few elements are dedicated to specific new entrants. PacTel further contends that we should not establish rules to insure nondiscriminatory provision of network elements because such rules will encourage litigation and the 1996 Act is self-effectuating. PacTel argues that we should consider claims of discrimination on a case-by-case basis through adjudication of complaints.[658] Both PacTel and USTA argue that the terms and conditions for the provision of unbundled elements should be resolved by private parties,

[654] MCI comments at 20-27; MCI reply at 28-30.

[655] AT&T comments at 33-39.

[656] PacTel comments at 40-44; USTA comments at 21-22; *see also* GTE comments at 24.

[657] USTA comments at 21-22; California Commission comments at 26-28; *see also* Colorado Commission comments at 27 (national technical standards are a laudable goal but should be carefully considered because of differences between incumbent LEC networks); Oregon commission comments at 24.

[658] PacTel comments at 30, 50-52; *accord* GVNW comments at 23-24 (requiring incumbent LECs to provide equivalent service is a negative incentives approach; the FCC will achieve nondiscriminatory provision of unbundled elements if it insures that incumbents are adequately compensated for such services).

the states, and industry fora.[659] The California Commission argues that the states are best situated to determine the terms and conditions for the provision of unbundled elements because they can best accommodate unique circumstances. The California Commission also argues that the Commission can determine whether the terms and conditions for the provision of unbundled elements are appropriate when the Commission evaluates BOC section 271 applications.[660]

305. Teleport argues that we must impose some method of enforcing terms and conditions applicable to unbundled elements, otherwise such regulations will not achieve their desired effect.[661] Thus, Teleport and a number of other potential competitors argue that we should impose penalties on incumbent LECs who fail to meet our standards.[662] MFS and NCTA argue that new entrants should be entitled to damages, and NCTA further contends that new entrants should be entitled to a reduction in rates for violations of our rules.[663] AT&T and Intermedia Communications argue that incumbents should be required to file reports demonstrating compliance with the terms and conditions established herein.[664] AT&T and others specifically request that the Commission require each incumbent LEC to file quarterly reports identifying the time intervals under which the incumbents have performed ordering, provisioning, and maintenance functions for competitors and for the incumbents' end-user customers.[665] MCI and Cable & Wireless argue that we should maintain oversight of the process by which incumbent LECs implement requests for unbundled elements.[666] PacTel opposes the imposition of penalties for failure to meet performance standards on the grounds that this will foster litigation and unwarranted claims of breach.[667]

---

[659] PacTel comments at 30, 40-44; USTA comments at 21-22.

[660] California Commission comments at 26-28; *see also* Oregon commission comments at 27.

[661] Teleport reply at 26-29.

[662] Teleport comments at 25-34, reply at 26-29; MCI comments at 20, reply at 28-30; NCTA comments at 44-46; Comcast comments at 24-25; Continental comments at 20.

[663] MFS comments at 16-17, 41; NCTA comments at 45-46.

[664] AT&T comments at 33-39; Intermedia comments at 3-6.

[665] *See, e.g.*, AT&T comments at 38; GCI comments at 9; Intermedia comments at 4-5; ACTA comments at 15.

[666] MCI comments at 21-27; Cable & Wireless comments at 36-37.

[667] Pactel comments at 30.

306. A number of potential entrants argue that the Commission should condition BOC entry into the in-region long distance market on fulfillment of the terms and conditions for the provision of unbundled elements.[668] Teleport argues that once the BOCs get into the in-region long distance market they will have no incentive to provide competitors with nondiscriminatory access to unbundled network elements.[669] PacTel, however, argues that we should conclude that the checklist in section 271 is satisfied if an incumbent LEC is providing unbundled elements as required by the Commission and states, and we should not consider the terms and conditions for the provision of unbundled elements in evaluating section 271 applications.[670]

3. Discussion

307. We agree with those commenters, including the Florida, Illinois and Washington Commissions, that to achieve the procompetitive goals of the 1996 Act, it is necessary to establish rules that define the obligations of incumbent LECs to provide nondiscriminatory access to unbundled network elements, and to provide such elements on terms and conditions that are just, reasonable and nondiscriminatory.[671] As discussed above at sections II.A, II.B and V.B, we believe that incumbent LECs have little incentive to facilitate the ability of new entrants, including small entities, to compete against them and, thus, have little incentive to provision unbundled elements in a manner that would provide efficient competitors with a meaningful opportunity to compete. We are also cognizant of the fact that incumbent LECs have the incentive and the ability to engage in many kinds of discrimination. For example, incumbent LECs could potentially delay providing access to unbundled network elements, or they could provide them to new entrants at a degraded level of quality.

308. Consistent with arguments advanced by the Florida and Washington Commissions, incumbent LECs, and potential competitors, and as more fully discussed in the specific sections below, we adopt general, national rules defining "nondiscriminatory access" to unbundled network elements, and "just, reasonable, and nondiscriminatory" terms and conditions for the provision of such elements. We have chosen this approach, rather than

---

[668] MCI comments at 21-27; Teleport comments at 25-34 (arguing that it is already experiencing service quality problems); Cable & Wireless comments at 36-37; TCC comments at 54-60; CompTel comments at 23-24; LDDS comments at 27.

[669] Teleport comments at 25-35.

[670] PacTel comments at 40-44.

[671] *See infra*, Section VII, for a discussion of just, reasonable and nondiscriminatory rates for unbundled network elements.

allowing states exclusively to consider these issues, because we believe that some national rules regarding nondiscriminatory access will reduce the costs of entry and speed the development of competition.[672]

309. We conclude, for example, that national rules defining the 1996 Act's requirements regarding nondiscriminatory access to, and provision of, unbundled elements will reduce costs associated with potential litigation over these issues, and will enable states to conduct arbitrations more quickly by reducing the number of issues they must consider. Such rules will also facilitate the ability of the Commission to conduct arbitrations, should we assume a state's responsibilities under section 252(e)(5). We conclude further that such rules will create some uniformity across states in connection with the terms under which new entrants may obtain access to network elements, thus facilitating the ability of potential competitors, including small entities, to enter local markets on a regional or national scale. Accordingly, for all of these reasons, we reject the arguments of PacTel and USTA that we should not adopt national rules relating to incumbent LEC obligations to provide access to, and provision, unbundled elements in a nondiscriminatory manner.

310. The record compiled in this proceeding supports the adoption of uniform general rules that rely on states to develop more specific requirements in arbitrations and other state proceedings. More significantly, however, we agree with the California and Florida Commissions that the states are best situated to issue specific rules because of their existing knowledge regarding incumbent LEC networks, capabilities, and performance standards in their separate jurisdictions and because of the role they will play in conducting mediations, arbitrations, and approving agreements. We expect that the states will implement the general nondiscrimination rules set forth herein by adopting, *inter alia*, specific rules determining the timing in which incumbent LECs must provision certain elements, and any other specific conditions they deem necessary to provide new entrants, including small competitors, with a meaningful opportunity to compete in local exchange markets. The states will continue to gain expertise in connection with issues relating to just, reasonable, and nondiscriminatory access and provision of unbundled network elements. We expect to turn to the states, and rely on the expertise they develop in this area, when we review and revise our rules as necessary.

311. We agree with those commenters that argue that incumbent LECs should be required to fulfill some type of reporting requirement to ensure that they provision unbundled elements in a nondiscriminatory manner. We believe the record is insufficient at this time to adopt such requirements, and we may reexamine this issue in the future. We encourage the

[672] *See supra*, Section V.B.

states, however, to adopt reporting requirements.[673] We decline to address whether the Commission should consider any of the terms and conditions adopted here in evaluating BOC applications to provide in-region long distance services. We will consider this issue, as it arises, when we evaluate individual BOC applications.

a. Nondiscriminatory Access to Unbundled Network Elements

312. We conclude that the obligation to provide "nondiscriminatory access to network elements on an unbundled basis"[674] refers to both the physical or logical connection to the element and the element itself. In considering how to implement this obligation in a manner that would achieve the 1996 Act's goal of promoting local exchange competition, we recognize that new entrants, including small entities, would be denied a meaningful opportunity to compete if the quality of the access to unbundled elements provided by incumbent LECs, as well as the quality of the elements themselves, were lower than what the incumbent LECs provide to themselves. Thus, we conclude it would be insufficient to define the obligation of incumbent LECs to provide "nondiscriminatory access" to mean that the quality of the access and unbundled elements incumbent LECs provide to all requesting carriers is the same. As discussed above with respect to interconnection,[675] an incumbent LEC could potentially act in a nondiscriminatory manner in providing access or elements to all requesting carriers, while providing preferential access or elements to itself. Accordingly, we conclude that the phrase "nondiscriminatory access" in section 251(c)(3) means at least two things: first, the quality of an unbundled network element that an incumbent LEC provides, as well as the access provided to that element, must be equal between all carriers requesting access to that element; second, where technically feasible, the access and unbundled network element provided by an incumbent LEC must be at least equal-in-quality to that which the incumbent LEC provides to itself.[676]

313. We believe that Congress set forth a "nondiscriminatory access" requirement in section 251(c)(3), rather then an absolute equal-in-quality requirement, such as that set forth in section 251(c)(2)(C), because, in rare circumstances, it may be technically infeasible for incumbent LECs to provide requesting carriers with unbundled elements, and access to such

[673] We address issues regarding enforcement of the rules we adopt in this Section, regarding nondiscriminatory access to, and just, reasonable and nondiscriminatory terms and conditions for the provision of unbundled network elements, at *supra*, in Section II.E.

[674] 47 U.S.C. § 251(c)(3).

[675] *See supra*, Sections IV.G, IV.H.

[676] We note that providing access or elements of lesser quality than that enjoyed by the incumbent LEC would also constitute an "unjust" or "unreasonable" term or condition.

elements, that are equal-in-quality to what the incumbent LECs provide themselves. According to some commenters, this problem arises in connection with one variant of one of the unbundled network elements we identify in this order. These commenters argue that a carrier purchasing access to a 1AESS local switch may not be able to receive, for example, the full measure of customized routing features that such a switch may afford the incumbent.[677] In the rare circumstances where it is technically infeasible for an incumbent LEC to provision access or elements that are equal-in-quality, we believe disparate access would not be inconsistent with the nondiscrimination requirement. Accordingly, we require incumbent LECs to provide access and unbundled elements that are at least equal-in-quality to what the incumbent LECs provide themselves, and allow for an exception to this requirement only where it is technically infeasible to meet.[678] We expect incumbent LECs to fulfill this requirement in nearly all instances where they provision unbundled elements because we believe the technical infeasibility problem will arise rarely. We further conclude, however, that the incumbent LEC must prove to a state commission that it is technically infeasible to provide access to unbundled elements, or the unbundled elements themselves, at the same level of quality that the incumbent LEC provides to itself.

314. Our conclusion that an incumbent LEC must provide unbundled elements, as well as access to them, that is "at least" equal in quality to that which the incumbent provides itself, does not excuse incumbent LECs from providing, when requested and where technically feasible, access or unbundled elements of higher quality.[679] As we discuss below,[680] we do not believe that this obligation is unduly burdensome to incumbent LECs because the 1996 Act requires a requesting carrier to pay the costs of unbundling, and thus incumbent LECs will be fully compensated for any efforts they make to increase the quality of access or elements within their own network.[681] Moreover, to the extent this obligation allows new entrants, including small entities, to offer services that are different from those offered by the

[677] *See infra*, Section V.J, discussing commenters' arguments regarding the possible technical limitations of such switches.

[678] The exception described here does not excuse incumbent LECs from the obligation to modify elements within their networks to allow requesting carriers to obtain access to such elements where this is technically feasible. *See supra*, Section IV.D.

[679] An incumbent LEC, in accommodating a carrier's request for a particular unbundled element, may ultimately provision an element that is higher in quality than what the incumbent provides to itself. *See infra*, Section V.J.1.

[680] *See infra*, Section V.J. We require, for example, that incumbent LECs provide local loops conditioned to enable the provision of digital services (where technically feasible) even if the incumbent does not itself provide such digital services.

[681] *See infra*, Section VII.

incumbent, we believe it is consistent with Congress's goal to promote local exchange competition. We note that, to the extent an incumbent LEC provides an element with a superior level of quality to a particular carrier, the incumbent LEC must provide all other requesting carriers with the same opportunity to obtain that element with the equivalent higher level of quality. We further note that where a requesting carrier specifically requests access or unbundled elements that are lower in quality to what the incumbent LECs provide themselves, incumbent LECs may offer such inferior quality if it is technically feasible. Finally, we conclude that the incumbent LEC must prove to a state commission that it is technically infeasible to provide access to unbundled elements, or the unbundled elements themselves, at a level of quality that is superior to or lower than what the incumbent LEC provides to itself.

b. Just, Reasonable and Nondiscriminatory Terms and Conditions for the Provision of Unbundled Network Elements

315. The duty to provide unbundled network elements on "terms, and conditions that are just, reasonable, and nondiscriminatory" means, at a minimum, that whatever those terms and conditions are, they must be offered equally to all requesting carriers, and where applicable, they must be equal to the terms and conditions under which the incumbent LEC provisions such elements to itself.[682] We also conclude that, because section 251(c)(3) includes the terms "just" and "reasonable," this duty encompasses more than the obligation to treat carriers equally. Interpreting these terms in light of the 1996 Act's goal of promoting local exchange competition, and the benefits inherent in such competition, we conclude that these terms require incumbent LECs to provide unbundled elements under terms and conditions that would provide an efficient competitor with a meaningful opportunity to compete. Such terms and conditions should serve to promote fair and efficient competition. This means, for example, that incumbent LECs may not provision unbundled elements that are inferior in quality to what the incumbent provides itself because this would likely deny an efficient competitor a meaningful opportunity to compete. We reach this conclusion because providing new entrants, including small entities, with a meaningful opportunity to compete is a necessary precondition to obtaining the benefits that the opening of local exchange markets to competition is designed to achieve.

316. As is more fully discussed below,[683] to enable new entrants, including small entities, to share the economies of scale, scope, and density within the incumbent LECs' networks, we conclude that incumbent LECs must provide carriers purchasing access to

[682] *See supras*, Sections IV.G, IV.H.

[683] *See infra*, Section V.J.

unbundled network elements with the pre-ordering, ordering, provisioning,[684] maintenance and repair, and billing functions of the incumbent LECs operations support systems. Moreover, the incumbent must provide access to these functions under the same terms and conditions that they provide these services to themselves or their customers. We discuss specific terms and conditions applicable to the unbundled elements identified in this order below, in Section V.J.

H. The Relationship Between Sections 251(c)(3) and 251(c)(4)

1. Background

317. Section 251(c)(4) provides that incumbent LECs must offer "for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers that are not telecommunications carriers."[685] In the NPRM, we asked for comment on the relationship between this provision and section 251(c)(3). Specifically, we asked whether carriers can order and combine network elements to offer the same services that incumbent LECs offer for resale under section 251(c)(4). We observed that different pricing standards under section 252(d) apply to unbundled elements under section 251(c)(3) and resold services under section 251(c)(4), and that section 251(c)(3) contemplates the purchase of unseparated facilities (*i.e.*, facilities that can be used for either inter- or intrastate services) while subsection (c)(4) does not necessarily contemplate this. We asked for comment on the implications or significance of these differences.[686]

2. Comments

318. A number of commenters, including incumbent LECs and CAPs, argue that, in order to distinguish section 251(c)(4) from section 251(c)(3), the Commission must conclude that new entrants can only obtain access to unbundled elements if they own or possess some local exchange facilities that they plan to use in combination with unbundled elements to provide a local service.[687] According to NYNEX, the 1996 Act contemplates that new

[684] The term "provisioning" includes installation.

[685] 47 U.S.C. § 251(c)(4).

[686] NPRM at para. 85.

[687] MFS comments at 36-40, 65-66; BellSouth comments at 31-33; Teleport comments at 39-42; Bell Atlantic comments at 14, reply at 5-6; Ameritech comments at 25-31; USTA comments at 23-26, reply at 10; TDS comments at 15-16; PacTel comments at 40-45; GTE reply at 17-18; SBC reply at 11; *accord* Pennsylvania Commission comments at 24; NYNEX comments at 29-39 (the FCC should state that new entrants can obtain unbundled elements to provide a service that is sold at resale only if they can self-provide, at a minimum, one of the elements used to provide the service).

entrants will enter local telephone markets either through section 251(c)(3) or section 251(c)(4). The former is designed for entrants with some of their own facilities, and would allow them to supplement their networks; the latter is designed for new entrants that do not possess any facilities.[688] MFS and Bell Atlantic concur and cite the legislative history to the 1996 Act.[689]

319. In support of this interpretation, some commenters cite the language of section 251(c)(3). Bell Atlantic contends that the phrase referring to unbundling at "any technically feasible point" means new entrants must have some of their own facilities to connect to that "point."[690] NYNEX argues that the phrase "such telecommunications service" excludes services provided by incumbents, and thus new entrants can only use unbundled elements to provide services that incumbents do not offer.[691]

320. Other commenters supporting this interpretation, including incumbent LECs and CAPs, contend that we must interpret the 1996 Act in a way that gives meaning to each provision. Accordingly, they argue that we cannot allow carriers to use unbundled elements exclusively to provide services that are available at resale, because to do so would make section 251(c)(4), and its associated pricing provision, section 252(d)(3), meaningless.[692] They assert that Congress established a more favorable pricing standard for unbundled elements than resold services to encourage facilities-based entry. They argue that Congress, recognizing that facilities-based carriers incur greater risks than resellers and are a more potent competitive force, created a statutory incentive to build competing facilities by

[688] NYNEX reply at 16-19 (the language of the 1996 Act and the legislative history show that resale takes precedence over the unbundling provision); *accord* MFS reply at 20-22 (unbundled elements are not meant as an alternative to wholesale services for pure resellers).

[689] MFS comments at 37-40; Bell Atlantic comments at 12-14 (*citing* Joint Explanatory Statement at 148, which provides that, because of the significant investment required to duplicate an incumbent's network, new entrants will require access to elements in the incumbents' networks to supplement the facilities owned by the new entrants); *see also* Ameritech comments at 25-31 (Congress intended unbundled elements to be used by carriers that have some of their own facilities because the provision allows carriers to purchase only the elements they need); NYNEX reply at 16-19 (there is no evidence in the 1996 Act or the legislative history indicating that Congress intended to allow carriers to use unbundled elements an alternative way to resell services); USTA comments at 59-66.

[690] Bell Atlantic comments at 12-14. *See also* USTA comments at 59-66.

[691] NYNEX reply at 16-19.

[692] MFS comments at 36-40, 65-66; BellSouth comments at 31-33; NYNEX reply at 16-19; Bell Atlantic comments at 12-14; Bell Atlantic reply at 5-6; *accord* Teleport comments at 39-43 (specific provisions prevail over general ones, and thus, if carriers use unbundled elements to replicate a wholesale service offering, the specific provision dictating the price for wholesale services should be applied rather than the general one for unbundled elements); GTE reply at 17 (the Commission should not deprive incumbent LECs of their compensatory return on resold services).

providing carriers who use unbundled elements with the opportunity to achieve higher profits. According to these commenters, if we allow carriers that merely resell services to obtain the financial benefits of unbundled elements, we would reward them though they have incurred little risk, and we would discourage them from building competing facilities.[693] BellSouth and Ameritech argue that the language of section 251(d)(2)(B) further supports this view because, if carriers can offer a service for resale, then such carriers are not "impaired in their ability to offer a service."[694]

321. Ameritech, NYNEX, and MFS argue that allowing carriers to provide the equivalent of a resold service exclusively through the use of unbundled elements would eviscerate the joint marketing restriction in section 271(e)(1) because there is no comparable restriction in this provision against the joint marketing of services provided through unbundled elements.[695] BellSouth and Ameritech further contend that this view is consistent with the terms of section 251(c)(4)(B), which allows states to prohibit resellers from offering a service to a category of consumers different than the category of consumers the incumbent LEC offers that service to. They contend that, if we allowed requesting carriers to offer resold services exclusively through unbundled elements, then such carriers could evade any possible prohibition on the sale of such services and the authority to impose such limitations on resale is reserved to the states.[696]

322. Finally, a number of incumbent LECs and MFS argue that new entrants should not be allowed to provide services available for resale exclusively through the use of unbundled elements because such entrants could underprice: facilities-based competitors, that must recover joint and common costs, and incumbent LECs, that charge above-cost prices for some services to support universal service obligations. If new entrants could underprice incumbent LECs, they assert, then the ability of the LECs to recover their costs and meet their universal service obligations would be diminished. They also contend that allowing the exclusive use of unbundled elements would lead to arbitrage based on the pricing standards for sections 251(c)(3) and 251(c)(4). They further contend that, if resold services are priced

[693] MFS comments at 37-40, reply at 20-23; Teleport comments at 39-43; NYNEX comments at 29-39; USTA comments at 23-26, reply at 8-10; Bell Atlantic comments at 12-14.

[694] BellSouth comments at 31-33; Ameritech comments at 25-31. For a further discussion of this argument *see supra*, Section V.E.

[695] Ameritech comments at 25-31, reply at 24; NYNEX reply at 16-19; MFS comments at 37-40 (further arguing that the prohibition against joint marketing through the use of resold services evidences Congress's preference for facilities-based competition).

[696] BellSouth comments at 31-33; Ameritech comments at 25-31.

below cost, this will discourage facilities-based entry through the purchase of unbundled elements.[697]

323. The Department of Justice and a number of potential competitors, including AT&T, Cable & Wireless, ALTS and LDDS, reject the view that, to give effect to section 251(c)(4), we must limit access to unbundled elements to those carriers who own some local exchange facilities. They argue that the 1996 Act allows carriers to use recombined network elements exclusively to provide services that are similar or identical to those offered by incumbent LECs for resale. To support this view they contend that the plain language of section 251(c)(3) does not contain any requirement that carriers must own some of their own local exchange facilities before they can purchase and use unbundled elements to provide a telecommunications service. According to these commenters, if we were to impose such a requirement, we would be reading into the 1996 Act a limitation on access to unbundled elements that is not stated anywhere within the statute.[698]

324. The parties which oppose conditioning access to unbundled elements on ownership of local exchange facilities also contend that sections 251(c)(3) and 251(c)(4) offer carriers different opportunities, and thus the rules of statutory construction do not require us to read use restrictions into section 251(c)(3) to distinguish and give meaning to section 251(c)(4).[699] AT&T, the Department of Justice, and others argue, for example, that carriers offering services through resale are limited to the precise service that the incumbent is providing. In contrast, these parties assert that carriers exclusively using unbundled elements can offer different and new services, or the same services with higher quality. In addition, these parties note that, under section 251(c)(3), carriers purchasing an unbundled element can provide all services which that element is typically used to provide, but under section

[697] Ameritech comments at 25-31, reply at 22; Bell Atlantic comments at 12-14, reply at 6; USTA comments at 23-26, reply at 8-10; MFS comments at 37-40, reply at 20-23; *accord* ALLTEL reply at 7; NYNEX comments at 29-39, reply at 16-19; Teleport comments at 39-43; PacTel reply at 25.

[698] AT&T comments at 28-31, reply at 12-20; TCC comments at 27-35; Cable & Wireless comments at 26-27, reply at 20-22; DoJ comments at 48-51, reply at 23-31; Sprint reply at 24-26; LDDS reply at 25-27; ALTS reply at 24-26; *but see* GTE reply at 17-18 (new entrants have just as much opportunity to offer new services through resale as they do through unbundled elements, with resold services new entrants can add value and develop new price plans).

[699] AT&T comments at 28-31, reply at 13-20; LDDS reply at 25-28; TCC comments at 27-35; CompTel reply at 13-22; DoJ comments at 48-51, reply at 23-31 (carriers will likely use resale to purchase services that incumbents price below cost, otherwise these services would never experience competition); Sprint comments at 24-26; Cable & Wireless comments at 20-22; MCI comments at 27-28 (carriers purchasing unbundled elements are not purchasing services, hence they are not the same thing as services available for resale).

251(c)(4), carriers purchasing services available for resale can only provide the service they purchase.[700]

325. Some of the commenters opposing restrictions on access to unbundled elements further argue that allowing carriers to use unbundled elements exclusively to provide the same or similar services that are sold at resale would reduce barriers to entry, and thus promote facilities-based competition. They explain that entrants using unbundled elements will incur lower costs, and will be able to offer more services than carriers who purchase services for resale. They further contend that this means that new entrants using unbundled elements will earn higher revenues, and will have more funds to build competing facilities, than carriers purchasing services available for resale. They also contend that a requirement that carriers own some facilities to purchase unbundled elements would impede entry into the access market and restrict competition for all local services to areas where construction of duplicate facilities is economically justified and has already occurred. Congress, they argue, did not intend to encourage the build out of competing facilities where it is not efficient and the reason Congress included the unbundling provision in the 1996 Act is because most areas only have one network.[701]

326. Some of the commenters who oppose restricting access to unbundled elements to those carriers who own some local exchange facilities also argue that any such restriction would be administratively burdensome and difficult to enforce. They contend, for example, that we would need to specify certain minimum facilities that carriers would need to own to obtain access to unbundled elements. They contend that, if we did not specify such minimum facilities, but merely required ownership or possession of a single facility (or any facility), then the requirement in general would have no practical significance.[702] The Department of Justice contends that we would need to determine whether carriers must own or possess a local exchange facility that is used for each consumer to whom they provide service.[703] In determining the relationship between sections 251(c)(3) and 251(c)(4), the Illinois Commission asks us to consider whether our interpretation would advance competition, reduce

[700] AT&T comments at 28-31, reply at 13-20; LDDS reply at 25-28; TCC comments at 27-35; CompTel reply at 13-22; DoJ comments at 48-51, reply at 23-31; Sprint comments at 24-26; Cable & Wireless comments at 20-22; MCI comments at 27-28.

[701] AT&T comments at 28-31, reply at 13-20; CompTel reply at 13-22; TCC comments at 27-35; DOJ comments at 48-51, reply at 23-31.

[702] DoJ comments at 48-51, reply at 23-31; AT&T reply at 13-20; Cable & Wireless reply at 20-22; LDDS reply at 25-30.

[703] DoJ comments at 48-51, reply at 23-31.

regulation, preserve and advance universal service, remove statutory, regulatory and economic impediments to new entry, and provide states with flexibility.[704]

327. Finally, NYNEX argues that carriers should not be permitted to offer services to consumers by combining unbundled elements and resold services because the different rates for unbundled elements and resale of services would allow for arbitrage.[705] Comptel and Sprint counter, however, that the 1996 Act does not prohibit the combined use of unbundled elements and resold services. Comptel further contends that Congress intended to provide new entrants with maximum flexibility in connection with opportunities to enter local telephone markets and thus it would be contrary to Congressional intent, as well as anticompetitive, if we prohibited carriers from using a combination of unbundled elements and services available for resale.[706]

3. Discussion

328. The language of section 251(c)(3) is cast exclusively in terms of obligations imposed on incumbent LECs, and it does not discuss, reference, or suggest a limitation or requirement in connection with the right of new entrants to obtain access to unbundled elements. We conclude, therefore, that Congress did not intend section 251(c)(3) to be read to contain any requirement that carriers must own or control some of their own local exchange facilities before they can purchase and use unbundled elements to provide a telecommunications service. We note that the Illinois Commission has reached the same conclusion.[707]

329. We reject the arguments advanced by Bell Atlantic and NYNEX that the language of section 251(c)(3) requires carriers seeking access to unbundled elements to own some local exchange facilities, and that this serves to distinguish section 251(c)(3) from section 251(c)(4). The "at any technically feasible point" language in section 251(c)(3) refers to points in an incumbent LEC's network where new entrants may obtain access to elements. It does not, however, require that new entrants interconnect local exchange facilities which they own or control at that technically feasible access point. If we were to conclude otherwise, then new entrants would be prohibited from requesting two network elements that

[704] Illinois Commission comments at 38.

[705] NYNEX comments at 38-39.

[706] CompTel reply at 20-22; Sprint comments at 23-28.

[707] AT&T Communications of Illinois, Inc. *et. al.*, Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company, Nos. 95-0458 and 95-0531 (consol.) at 63-65 (Illinois Commission June 26, 1996).

are connected to each other because the new entrant would be required to connect a single network element to a facility of its own. The 1996 Act, however, does not impose any limitations on carriers' ability to obtain access to unbundled network elements. Moreover, we conclude that Congress did not intend to limit access to unbundled elements in this manner because such a limit would seriously inhibit the ability of potential competitors to enter local markets through the use of unbundled elements, and thus would retard the development of local exchange competition. We also reject NYNEX's argument that the phrase "such telecommunications service" excludes services provided by the incumbent. This interpretation is inconsistent with the 1996 Act's definition of a telecommunications service, which includes all telecommunications services provided by an incumbent.

330. We also reject the argument that language in the Joint Explanatory Statement requires us to conclude that carriers must own facilities to obtain access to unbundled elements. Congress may have recognized that carriers that own some of their own facilities will more likely benefit by entering local markets through unbundled elements rather than resale, but this consideration does not imply that carriers must own their own facilities to obtain access to unbundled elements.[708]

331. We are not persuaded that, in order to give meaning and effect to section 251(c)(4), we must require new entrants to own some local exchange facilities in order to obtain access to unbundled elements. We disagree with the premise that no carrier would consider entering local markets under the terms of section 251(c)(4) if it could use recombined network elements solely to offer the same or similar services that incumbents offer for resale. We believe that sections 251(c)(3) and 251(c)(4) present different opportunities, risks, and costs in connection with entry into local telephone markets, and that these differences will influence the entry strategies of potential competitors. We therefore find that it is unnecessary to impose a limitation on the ability of carriers to enter local markets under the terms of section 251(c)(3) in order to ensure that section 251(c)(4) retains functional validity as a means to enter local phone markets.

332. The principal distinction between sections 251(c)(3) and 251(c)(4), in terms of the opportunities each section presents to new entrants, is that carriers using solely unbundled elements, compared with carriers purchasing services for resale, will have greater opportunities to offer services that are different from those offered by incumbents. More specifically, carriers reselling incumbent LEC services are limited to offering the same service an incumbent offers at retail. This means that resellers cannot offer services or products that incumbents do not offer. The only means by which a reseller can distinguish the services it offers from those of an incumbent is through price, billing services, marketing efforts, and to some extent, customer service. The ability of a reseller to differentiate its products based on

[708] *See* Joint Explanatory Statement at 148.

price is limited, however, by the margin between the retail and wholesale price of the product.

333. In contrast, a carrier offering services solely by recombining unbundled elements can offer services that differ from those offered by an incumbent. For example, some incumbent LECs have capabilities within their networks, such as the ability to offer Centrex, which they do not use to offer services to consumers. Carriers purchasing access to unbundled elements can offer such services. Additionally, carriers using unbundled elements can bundle services that incumbent LECs sell as distinct tariff offerings, as well as services that incumbent LECs have the capability to offer, but do not, and can market them as a bundle with a single price. The ability to package and market services in ways that differ from the incumbent's existing service offerings increases the requesting carrier's ability to compete against the incumbent and is likely to benefit consumers.[709] Additionally, carriers solely using unbundled network elements can offer exchange access services. These services, however, are not available for resale under section 251(c)(4) of the 1996 Act.[710]

334. If a carrier taking unbundled elements may have greater competitive opportunities than carriers offering services available for resale, they also face greater risks. A carrier purchasing unbundled elements must pay for the cost of that facility, pursuant to the terms and conditions agreed to in negotiations or ordered by states in arbitrations.[711] It thus faces the risk that end-user customers will not demand a sufficient number of services using that facility for the carrier to recoup its cost. (Many network elements can be used to provide a number of different services.) A carrier that resells an incumbent LEC's services does not face the same risk. This distinction in the risk borne by carriers entering local markets through resale as opposed to unbundled elements is likely to influence the entry strategies of various potential competitors. Some new entrants will be unable or unwilling to bear the financial risks of entry by means of unbundled elements and will choose to enter local markets under the terms of section 251(c)(4) irrespective of the fact that they can obtain access to unbundled elements without owning any of their own facilities.[712] Moreover, some markets may never support new entry through the use of unbundled elements because new entrants seeking to offer services in such markets will be unable to stimulate sufficient demand to recoup their investment in unbundled elements. Accordingly, in these markets

[709] *See* AT&T comments at 25-31.

[710] *See infra*, Section VII; *see also* Letter from Bernard J. Ebbers, President LDDS WorldCom, to Rachelle B. Chong, Commissioner, Federal Communications Commission, July 11, 1996.

[711] *See infra*, Section VII, describing the terms under which new entrants will pay for the cost of unbundled elements.

[712] *See, e.g.*, AT&T reply at 13-20.

carriers will enter through the resale of incumbent LEC services, irrespective of the fact that they could enter exclusively through the use of unbundled elements.[713]

335. We are not persuaded by the argument set forth by Ameritech, NYNEX, and MFS that allowing carriers to use solely recombined network elements would eviscerate the joint marketing restriction in section 271(e)(1).[714] It is true that the terms of section 271(e) do not restrict joint marketing through the use of unbundled elements pursuant to section 251(c)(3). As discussed above, differences in opportunities and risk will cause some new entrants to consider entering local telephone markets through resale of incumbent LEC services, even if they could enter solely through the use of unbundled elements. Thus, we conclude that section 271(e)(1) will impose a meaningful limitation on joint marketing.

336. We note, moreover, that the 1996 Act does not prohibit all forms of joint marketing. For example, it does not prohibit carriers who own local exchange facilities from jointly marketing local and interexchange service. Nor does it prohibit joint marketing by carriers who provide local exchange service through a combination of local facilities which they own or possess, and unbundled elements. Because the 1996 Act does not prohibit all forms of joint marketing, we see no principled basis for reading into section 271(e)(1) a further limitation on the ability of carriers to jointly market local and long distance services without concluding that this section prohibits all forms of joint marketing. In other words, we see no basis upon which we could conclude that section 271(e)(1) restricts joint marketing of long distance services, and local services provided solely through the use of unbundled network elements, without also concluding that the section restricts the ability of carriers to jointly market long distance services and local services that are provided through a combination of a carriers' own facilities and unbundled network elements.[715] Moreover, we do not believe that we have the discretion to read into the 1996 Act a restriction on competition which is not required by the plain language of any of its sections.

337. We also reject the argument advanced by BellSouth and Ameritech that allowing carriers to use solely unbundled elements to provide services available through resale would allow carriers to evade a possible prohibition, which is reserved to the discretion of the states,

[713] *See, e.g.*, Comptel reply at 13-16.

[714] Section 271(e)(1) provides that "[u]ntil a Bell operating company is authorized pursuant to subsection (d) to provide interLATA services in an in-region State, or until 36 months have passed since the date of enactment . . . a telecommunications carrier that serves greater than 5 percent of the Nation's presubscribed access lines may not jointly market in such State telephone exchange service obtained from such company pursuant to section 251(c)(4) with interLATA services." 47 U.S.C. § 271(e)(1).

[715] *See also* AT&T reply at 14-15 (the added risk of unbundled elements also means that new entrants are not circumventing section 271's joint marketing restriction because the additional risk justifies allowing carriers more flexibility to jointly market services); LDDS reply at 28-30.

on the sale of certain services to certain categories of consumers. Under section 251(c)(4)(B) states are permitted to restrict resellers from offering certain services to certain consumers, in the same manner that states restrict incumbent LECs.[716] For example, states that prohibit incumbent LECs from selling to business consumers residential services priced below cost have the ability to restrict resellers from selling such services to business consumers.

338. We do not believe, however, that carriers using solely unbundled elements to provide local exchange services will be able to evade any potential restrictions states may impose under section 251(c)(4)(B). In this section Congress granted the states the discretion to impose certain limited restrictions on the sale of services available for resale. It did not, however, grant states, in section 251(c)(3), the same discretion to impose similar restrictions on the use of unbundled elements. Accordingly, we are not persuaded that allowing carriers to use solely unbundled elements to provide services that incumbent LECs offer for resale would allow competing carriers to evade a possible marketing restriction that Congress intended to reserve to the discretion of the states.

339. We agree with those commenters who argue that it would be administratively impossible to impose a requirement that carriers must own some of their own local exchange facilities in order to obtain access to unbundled elements, and they must use these facilities, in combination with unbundled elements, for the purpose of providing local services. We conclude that it would not be possible to identify the elements carriers must own without creating incentives to build inefficient network architectures that respond not to marketplace factors, but to regulation. We further conclude that such a requirement could delay possible innovation. These effects would diminish competition for local telephone services, and thus any local exchange facilities requirement would be inconsistent with the 1996 Act's goals of promoting competition. Moreover, if we imposed a facilities ownership requirement that attempted to avoid these competitive pitfalls, it would likely be so easy to meet it would ultimately be meaningless.

340. We reject the argument that requiring carriers to own some local exchange facilities would promote competition for local exchange services, or that we should impose such a requirement for other policy reasons. To the contrary, we conclude that allowing carriers to use unbundled elements as they wish, subject only to the maintenance of the key elements of the access charge regime, described below at section VII, will lead to more efficient competition in local phone markets. If we were to limit access to unbundled network elements to those markets where carriers already own, or could efficiently build, some local exchange facilities, we would limit the ability of carriers to enter local markets under the pricing standard for unbundled elements to those markets that could efficiently support duplication of some or all of the incumbent LECs' networks. We believe that such a result could diminish competition, and that allowing new entrants to take full advantage of

[716] 47 U.S.C. § 251(c)(4)(B).

incumbent LECs' scale and scope economies will promote more rapid and efficient entry and will result in more robust competition.

341. Finally, we conclude that a new entrant may offer services to one group of consumers using unbundled network elements, and it may offer services to a separate group of consumers by reselling an incumbent LEC's services. With the exception noted in Section VII, *infra*, we do not address the issue of whether the 1996 Act permits a new entrant to offer services to the same set of consumers through a combination of unbundled elements and services available for resale.

I. Provision of Interexchange Services Through The Use of Unbundled Network Elements

1. Background

342. In the NPRM, we tentatively concluded that interexchange carriers are telecommunications carriers, and thus such carriers are entitled to access to unbundled elements under the terms of section 251(c)(3). We also tentatively concluded that carriers may request unbundled elements for purposes of originating and terminating toll services, in addition to any other services they seek to provide, because section 251(c)(3) provides that carriers may request unbundled elements to provide a "telecommunications service," and interexchange services are a telecommunications service.[717]

343. In the NPRM, we sought comment on whether the 1996 Act permits carriers to use unbundled elements to provide exchange access services only, or whether carriers seeking to provide exchange access services using unbundled elements must provide local exchange service as well. We premised the latter view on the definition of the term "network element," as a facility and not a service, and on the pricing standard under section 252(d)(1) that requires network elements to be priced based on economic costs (rather than jurisdictionally separated costs.)[718] We also sought comment on whether allowing carriers to purchase unbundled elements to provide exchange access services exclusively would be inconsistent with the terms of sections 251(i) and 251(g) and, further, whether this would result in a fundamental jurisdictional shift of the administration of interstate access charges to state jurisdictions.[719]

[717] NPRM at paras. 159, 163.

[718] *See supra*, Section V.C. and *infra*, Section VII.

[719] NPRM at para. 164.

344. Finally, in the NPRM, we tentatively concluded that, if carriers purchase unbundled elements to provide exchange access services to themselves, irrespective of whether they provide such services alone or in connection with local exchange services, incumbent LECs cannot assess Part 69 access charges in addition to charges for the cost of the unbundled elements. We based this tentative conclusion on the view that the imposition of access charges in addition to cost-based charges for unbundled elements would depart from the statutory mandate of cost-based pricing of elements.[720]

2. Comments

345. A number of potential competitors, as well as the Department of Justice, the Illinois and Ohio Commissions, NYNEX, and USTA, agree with our tentative conclusions that interexchange carriers may obtain access to unbundled elements, and that carriers may purchase unbundled elements for the purpose of originating and terminating interexchange services because such services are a type of telecommunications service.[721] Some of these commenters support our tentative interpretation of the 1996 Act by arguing that section 251(c)(3) requires incumbent LECs to provide access to network elements without regard to the types of services carriers seek to offer, or the jurisdictional nature of such services. They contend that new entrants are paying the full cost for an element and thus are entitled to recover their costs by offering any services that use the element.[722] Others argue that, by its plain terms, the 1996 Act does not allow incumbent LECs to limit the types of services any carrier can offer in connection with the sale of unbundled elements.[723]

346. The Department of Justice and AT&T also contend that there are substantial economies of scope in the provision of local exchange and exchange access services, and that new entrants will need the revenue streams from both services to support the high cost of

[720] NPRM at para. 165.

[721] NYNEX comments at 20-22; TCC comments at 27-35; Sprint comments at 67-70, reply at 32-34; Cable & Wireless comments at 27-32, reply at 20; MCI comments at 77-83; COMAV comments at 31; DoJ comments at 35-47; CompTel comments at 27,65; Frontier comments at 11, reply at 8-11; Illinois Commission at 51-52; Ohio Commission comments at 57-58; AT&T reply at 23-24; LDDS reply at 36-38; Excel comments at 4; TCC comments at 28; USTA comments at 59-66; *see also* Texas Public Utility Counsel comments at 39-40 (competition will push access rates to cost so the Commission should not put effort into protecting access charges); Citizens Utilities comments at 22.

[722] *See, e.g.*, DoJ comments at 35-47; AT&T reply at 23-24; TCC comments at 27-35; LDDS reply at 36-38 (because carriers pay the full unseparated cost of a network element, they are entitled to provide the full range of services over those elements); Excel comments at 4; TCC comments at 28; Frontier reply at 24-26.

[723] *See, e.g.*, DoJ comments at 35-47; Illinois Commission comments at 51-52; MCI comments at 77-84.

constructing competing local exchange facilities.[724] The Department of Justice and Comptel further assert that, if incumbent LECs are allowed to maintain market power over exchange access services then, when the BOCs are allowed into in-region long distance markets, the BOCs will be able to underprice other competitors in the sale of long distance services, and in the sale of bundled local and long distance services, and thus could undermine current competitive conditions in the long distance market.[725]

347. The commenters which support our tentative conclusion that carriers may use unbundled elements to provide interexchange services disagree, however, on whether requesting carriers can use unbundled elements solely to provide interexchange services or whether they must provide other services, including local services, as well. AT&T, MCI, Cable & Wireless, and GCI argue that the ability to provide exchange access services is a function of the loop, and the plain language of the 1996 Act does not permit incumbent LECs to deny requesting carriers the ability to obtain that functionality alone.[726] Sprint and the Department of Justice, however, contend that, while the 1996 Act does not prohibit carriers purchasing unbundled elements from offering only exchange access services, as a practical matter, any carrier purchasing access to a local loop will have to offer both local exchange and exchange access services.[727] The Department of Justice bases its contention on the assumption that the Commission will require carriers purchasing access to a local loop to take exclusive control of that loop. The Department of Justice explains that such a requirement is consistent with section 252's method for pricing network elements and with industry practice at the time the 1996 Act was adopted.[728] Sprint bases its contention on the view that allowing carriers to obtain access to local loops in order to provide only a single service is inconsistent with the idea that a network element is a facility and not a service.[729] The Department of

[724] DoJ comments at 35-47; AT&T reply at 23-24.

[725] CompTel comments at 19-27; DoJ comments at 35-47.

[726] AT&T reply at 23-24; Cable & Wireless comments at 27-32; MCI comments at 77-84 (defining a local loop as a single network element is inconsistent with the 1996 Act's definition of a network element which states that a functionality can be a network element); GCI comments at 11; *see also* ACTA comments at 17; Excel comments at 4.

[727] Sprint comments at 67-70, reply at 34-36; DoJ comments at 35-47; *see also* LDDS reply at 37; *cf.* Citizens Utilities at 22 (it is unlikely that IXCs will purchase unbundled elements to provide solely exchange access services, because in the future they will market services through "one stop shopping," where they will offer local and long distance services as a bundled product); MFS comments at 65-66 (to meet market demand carriers will have to offer the services customers demand, and it is unlikely they will want only interexchange services).

[728] DoJ comments at 35-47.

[729] Sprint comments at 67-70.

Justice and Sprint thus argue that any carrier purchasing exclusive access to a local loop would have to provide all services demanded by the customer to whom that loop is dedicated. If a customer desires to receive both local exchange and exchange access services, then the carrier purchasing access to that customer's loop would have to provide both of these services.[730] Sprint observes, in contrast, that if a customer has two local loops dedicated to its premises a carrier could purchase access to one of the loops merely to provide exchange access services, because the customer could receive local exchange service from another carrier over the other local loop.[731]

348. In contrast, NYNEX, USTA, the Ohio Commission, and Puerto Rico Telephone argue that the 1996 Act does not impose any obligation on incumbent LECs to provide access to unbundled elements solely to allow carriers to provide originating and terminating exchange access services. They argue that carriers purchasing access to local loops in order to provide exchange access services must also provide local exchange services as well.[732] USTA supports its contention by arguing that, in order to obtain "access to" unbundled network elements, a carrier must "interconnect" to them under the terms of section 251(c)(2), but that carriers are eligible for interconnection under section 251(c)(2) only if they offer both local exchange and exchange access services. Accordingly, USTA asserts that carriers that interconnect to unbundled elements must offer both of these services.[733] NYNEX argues that sections 251(g) and (i), and the legislative history to the 1996 Act, make clear that Congress did not intend for section 251 to supplant the existing access charge regime, and that carriers thus can not obtain unbundled local loops merely to offer exchange access services. Carriers seeking access to unbundled loops must take the entire functionality of this element, and thus will have to offer both local exchange and exchange access services.[734] Puerto Rico Telephone further argues that the subsidies built into access charge prices enable incumbent LECs to meet their universal service obligations, and that a premature elimination of this contribution would cause massive increases in local service rates.[735]

[730] Sprint comments at 67-70; DoJ comments at 35-47; *accord* LDDS reply at 37.

[731] Sprint comments at 67-70.

[732] NYNEX comments at 6, 21-22; USTA comments at 59-66; Ohio Commission comments at 57-58; Puerto Rico Tel. comments at 11-14.

[733] USTA comments at 56-66.

[734] NYNEX comments at 6, 20-22; *see also* USTA comments at 56-66 (concurring with NYNEX's reasoning).

[735] Puerto Rico Tel. comments at 11-14; *see also* USTA reply comments at 6-8; SBC comments at 77-82 (allowing carriers to use unbundled elements to provide themselves exchange access will result in arbitrage between the price of unbundled network elements and access charges); PacTel reply at 35-36.

349. Disputing our tentative conclusion, a number of incumbent LECs contend that the 1996 Act prohibits interexchange carriers from purchasing unbundled elements to provide exchange access services to themselves and thus avoid payment of access charges to incumbent LECs.[736] Bell Atlantic contends that carriers purchasing unbundled elements from an incumbent LEC must pay access charges for toll calls completed on that incumbent LEC's network. Thus, for example, if a carrier purchases an unbundled loop, and completes toll calls using its own switch and the unbundled loop, it must pay the incumbent LEC from which it purchased the loop both the cost of the loop and the carrier common line charge associated with it.[737]

350. The commenters opposing interexchange carriers' use of unbundled elements to provide interexchange services offer a number of arguments to support their view. For example, they argue that section 251(g) means that incumbent LECs must offer exchange access services under the same terms that they did prior to the passage of the 1996 Act, and the "receipt of compensation" phrase in this section means that interexchange carriers must continue to pay current access charges until they are reformed in an access charge rulemaking proceeding.[738] They also argue that the express language of section 251(i) makes clear that the Commission's section 201 authority to regulate interstate access charges is not overridden by section 251(c)(3). They assert that, if we interpret section 251(c)(3) as allowing carriers to use unbundled elements to provide interexchange services, then our section 201 authority to regulate interstate access charges would be limited, in violation of section 251(i).[739] They further argue that allowing carriers to use unbundled elements to provide exchange access services to themselves, and interexchange services to end users, would be "inconsistent" with the purposes of section 251, which was designed to promote competition for local telephone

[736] BellSouth comments at 30-31, 60-63, reply at 45-46; Bell Atlantic comments at 8-12; Texas Statewide Tel. Cooperative, Inc. comments at 16-17; PacTel comments at 78-80; ALLTEL reply at 6-7; Rural Tel. Coalition reply at 7-11; Ameritech comments at 26, reply at 25; SBC comments at 77-82; PacTel reply at 36; U S West comments at 59-64, reply at 6-8; *see also* NECA comments at 3-6; GTE comments at 74-79 (carriers using unbundled network elements to originate and terminate toll services should be required to charge their interexchange affiliate the same access prices they charge unaffiliated carriers).

[737] Bell Atlantic comments at 8-12.

[738] *See, e.g.*, BellSouth comments at 63-64; Texas Statewide Tel. Cooperative, Inc. comments at 16-17; Bell Atlantic comments at 8-12; Time Warner comments at 60-63; PacTel comments at 78-80, reply at 36; NECA comments at 3-6, reply at 5; SBC comments at 77-82; *see also* USTA comments at 5-8; GTE comments at 74-79; U S West comments at 61; ALLTEL reply at 6-7; Rural Tel. Coalition reply at 7-11.

[739] BellSouth comments at 63-64; USTA comments at 59-66; NYNEX comments at 9-21; Bell Atlantic comments at 8-12; Time Warner comments at 60-63; Puerto Rico Tel. comments at 10-14; Texas Statewide Tel. Cooperative, Inc. comments at 16-17; NECA reply at 5; GTE comments at 74-79; Rural Tel. Coalition reply at 7-11.

services and was not intended as a means to evade access charges.[740] They further argue that such an interpretation would transfer control of interstate access charges to the states.[741]

351. SBC, PacTel and GTE argue that the Senate version of the 1996 Act (which was amended by the Conference Committee) makes clear that section 251 was not intended to supplant the existing access charge regime.[742] PacTel further argues that section 251(c)(3) allows carriers to obtain unbundled elements to "offer" telecommunications services, but not to receive exchange access services.[743] Time Warner contends that none of the provisions of the 1996 Act displace section 201, which grants the Commission authority to establish access charges.[744] NECA contends that the Commission may not change the separations rules that allocate costs between interstate and intrastate jurisdictions without a recommendation from the Joint Board and that it cannot modify or repeal interstate access charge rules without a formal rulemaking. Accordingly, NECA concludes, carriers must still pay interstate access charges.[745] NECA also argues that, because carriers could offer long distance services without using unbundled elements, under the "impairment" standard in section 251(d)(2), incumbent LECs need not provide unbundled elements to enable carriers to offer interexchange services.[746]

352. SBC also argues that allowing carriers to use unbundled elements to provide interexchange services will decrease the incentives for new entrants to invest in competing facilities. As a result, SBC concludes consumers are not likely to benefit because new

[740] BellSouth comments at 63-64, reply at 45-46; Bell Atlantic reply at 4-6; Texas Statewide Tel. Cooperative, Inc. comments at 16-17; Ameritech reply at 25-26; SBC comments at 77-82 (the terms of section 251 relate only to interconnection between carriers offering local exchange services); Bell Atlantic comments at 8-12; Bay Springs, *et al.* comments at 16; *see also* Minnesota Ind. Coalition comments at 34-38 (interexchange service is not an incumbent LEC exchange service and thus IXCs should not be allowed to circumvent access charges).

[741] BellSouth comments at 63-64; NYNEX comments at 9-21; U S West comments at 59-66; GTE comments at 74-79; PacTel reply at 36; *see also* Rural Tel. Coalition reply at 7-11.

[742] SBC comments at 77-82; GTE comments at 74-79; PacTel comments at 78-80; *see also* NECA comments at 3-6.

[743] PacTel comments at 78-80.

[744] Time Warner comments at 60-63.

[745] NECA comments at 3-6, reply at 3-7.

[746] NECA reply at 5-6.

entrants will price exchange access services just below the levels charged by incumbent LECs.[747] SBC and NECA contend that section 251(d)(3) preserves the authority of states over intrastate access charges.[748] Bell Atlantic contends that Congress could not have intended to overturn the existing access charge regime without expressly stating this.[749] Finally, Bell Atlantic and Ameritech argue that it would be inappropriate to allow carriers to use unbundled elements to provide interexchange services because this would amount to a flash cut reform of access charges before universal service issues are addressed. They reason that, since interstate access charges subsidize local service prices, to allow access pricing to be circumvented would prevent incumbent LECs from meeting their universal service obligations and would, thus, jeopardize current local phone rates.[750] The Rural Telephone Coalition agrees and notes, in particular, that rural ratepayers could be subject to higher local service rates if interexchange carriers are allowed, before proceedings regarding access reform and universal service are completed, to bypass access charges through the purchase of unbundled elements.[751]

353. A number of potential competitors dispute the incumbent LECs' arguments. MCI and the Department of Justice contend that section 251(g) means that the exchange access rules applicable to incumbent LECs before the 1996 Act was passed continue to apply until the Commission issues "superseding regulations." Citing the Joint Explanatory Statement, they assert that the "superseding regulations" referred to are the regulations that the Commission must issue to implement the requirements of section 251. They argue that if section 251 did not affect some change in the rules on access charges, then the "receipt of compensation" language in section 251(g) would be unnecessary.[752]

354. With respect to section 251(i), Cable & Wireless contends that this section merely preserves the Commission's authority under section 201. According to Cable &

---

[747] SBC reply at 9-11.

[748] SBC comments at 77-82; NECA comments at 3-6; *see also* NYNEX comments at 9-21 (allowing carriers to use unbundled elements to provide exchange access services to themselves would preempt state access charge policies).

[749] Bell Atlantic comments at 8-12;

[750] Bell Atlantic comments at 8-12, reply at 4-6; Ameritech reply at 24-26 (prices for exchange access services should be rebalanced through a direct examination of universal service issues); *see also* USTA comments at 61.

[751] Rural Tel. Coalition reply at 8.

[752] DoJ comments at 52-53; MCI comments at 77-84. *But cf.* GTE reply at 39-40 (the argument that section 251(g) serves to preserve existing access charges until the Commission adopts regulations implementing section 251 deprives section 251(g) of any meaning because there is no need to preserve existing access charges).

Wireless, this means that carriers can obtain originating and terminating access either by purchasing unbundled network elements under section 251(c)(3) or pursuant to access charge tariffs.[753] MCI argues that section 251(i) preserves the Commission's authority to regulate interstate access charges where incumbent LECs are still providing these services (rather then where new entrants are using unbundled elements.)[754] MCI also argues that allowing carriers to use unbundled elements to provide originating and terminating toll services would not deprive the Commission of authority to set prices for exchange access services because in this proceeding the Commission will direct the states on how to set prices for unbundled elements.[755]

355. LDDS denies that the language of the Senate (as well as House) versions of the 1996 Act indicate that section 251 was not intended to supplant the existing access charge structure, and points to the fact that the language in these bills supporting this argument was not included in the final bill as amended by the Conference Committee.[756] MCI and LDDS argue, respectively, that allowing carriers to use unbundled elements to provide exchange access services is not inconsistent with Congress' intent in writing section 251 because Congress intended for the 1996 Act to create a single set of rules governing relationships between carriers,[757] and the 1996 Act is also about eliminating inefficient pricing in telecommunications services, including inefficient pricing of current access charges.[758] Frontier contends that the statutorily-mandated rates that incumbent LECs may charge for unbundled elements will not be the same as the rates they charge for exchange access services. Frontier argues, however, that the correct response to this is not to limit the purposes for which unbundled elements may be used, but to reform access charge prices to reflect costs.[759] Finally, the Ohio Commission and a number of potential local competitors agree with our tentative conclusion that incumbent LECs cannot assess part 69 access charges

---

[753] Cable & Wireless comments at 26-32 (arguing same point in connection with section 251(g)); *see also* CompTel comments at 66.

[754] MCI comments at 77-83.

[755] *Id.*

[756] LDDS reply at 32.

[757] MCI comments at 77-83.

[758] LDDS reply at 30-32.

[759] Frontier reply at 9-11.

on top of prices for unbundled network elements because this would allow incumbent LECs to recover fees in excess of costs, in violation of the pricing standards in section 252.[760]

3. Discussion

356. We confirm our tentative conclusion in the NPRM that section 251(c)(3) permits interexchange carriers and all other requesting telecommunications carriers, to purchase unbundled elements for the purpose of offering exchange access services, or for the purpose of providing exchange access services to themselves in order to provide interexchange services to consumers.[761] Although we conclude below that we have discretion under the 1934 Act, as amended by the 1996 Act, to adopt a limited, transitional plan to address public policy concerns raised by the bypass of access charges via unbundled elements, we believe that our interpretation of section 251(c)(3) in the NPRM is compelled by the plain language of the 1996 Act. As we observed in the NPRM, section 251(c)(3) provides that requesting telecommunications carriers may seek access to unbundled elements to provide a "telecommunications service," and exchange access and interexchange services are telecommunications services. Moreover, section 251(c)(3) does not impose restrictions on the ability of requesting carriers "to combine such elements in order to provide such telecommunications service[s]."[762] Thus, we find that there is no statutory basis upon which we could reach a different conclusion for the long term.

357. We also confirm our conclusion in the NPRM that, for the reasons discussed below in section V.J, carriers purchase rights to exclusive use of unbundled loop elements, and thus, as the Department of Justice and Sprint observe, such carriers, as a practical matter, will have to provide whatever services are requested by the customers to whom those loops are dedicated. This means, for example, that, if there is a single loop dedicated to the premises of a particular customer and that customer requests both local and long distance service, then any interexchange carrier purchasing access to that customer's loop will have to offer both local and long distance services. That is, interexchange carriers purchasing unbundled loops will most often not be able to provide solely interexchange services over those loops.

358. We reject the argument advanced by a number of incumbent LECs that section 251(i) demonstrates that requesting carriers using unbundled elements must continue to pay

[760] Ohio Commission comments at 58; TCC comments at 27-35; Sprint comments at 67-70; MCI comments at 73; DoJ comments at 35-47,52-53; CompTel comments at 39; Excel comments at 4; AT&T reply at 23-24; LDDS reply at 36-38.

[761] *See* NPRM at paras. 159-65.

[762] 47 U.S.C. § 251(c)(3).

access charges. Section 251(i) provides that nothing in section 251 "shall be construed to limit or otherwise affect the Commission's authority under section 201."[763] We conclude, however, that our authority to set rates for these services is not limited or affected by the ability of carriers to obtain unbundled elements for the purpose of providing interexchange services. Our authority to regulate interstate access charges remains unchanged by the 1996 Act. What has potentially changed is the volume of access services, in contrast to the number of unbundled elements, interexchange carriers are likely to demand and incumbent LECs are likely to provide. When interexchange carriers purchase unbundled elements from incumbents, they are not purchasing exchange access "services." They are purchasing a different product, and that product is the right to exclusive access or use of an entire element. Along this same line of reasoning, we reject the argument that our conclusion would place the administration of interstate access charges under the authority of the states. When states set prices for unbundled elements, they will be setting prices for a different product than "interstate exchange access services." Our exchange access rules remain in effect and will still apply where incumbent LECs retain local customers and continue to offer exchange access services to interexchange carriers who do not purchase unbundled elements, and also where new entrants resell local service.[764]

359. We also reject the incumbent LECs' arguments that language contained in bills that were not enacted, or legislative history connected to such bills, demonstrates that carriers cannot purchase access to unbundled elements to provide exchange access services to themselves, for the purpose of providing long distance services to consumers. The incumbent LECs are arguing in effect, that we should read into the current statute a limitation on the ability of carriers to use unbundled network elements, despite the fact that no such limitation survived the Conference Committee's amendments to the 1996 Act. We conclude, however, that the language of section 251(c)(3), which provides that telecommunications carriers may purchase unbundled elements in order to provide a telecommunications service[765] is not ambiguous. Accordingly, we must interpret it pursuant to its plain meaning and not by referencing earlier versions of the statute that were ultimately not adopted by Congress.

360. Moreover, we do not believe that the Joint Explanatory Statement, which describes the House and Senate versions of the statute, and the 1996 Act as enacted, compels a different conclusion. The Joint Explanatory Statement states that the statute incorporates provisions from the Senate Bill and the House Amendment in connection with the

[763] 47 U.S.C. § 251(i).

[764] The application of our exchange access rules in the circumstances described will continue beyond the transition period described at *infra*, Section VII.

[765] 47 U.S.C. § 251(c)(3).

interconnection model adopted in section 251.[766] It notes that the provision in the Senate Bill relating to interconnection did not apply to interconnection arrangements between local and long distance carriers for the purpose of providing long distance services.[767] The text of section 251 of the Senate Bill is consistent with this comment because it states that a local exchange carrier must offer interconnection to other carriers to allow such carriers to provide telephone exchange or exchange access services.[768] The Joint Explanatory Statement, however, does not describe any restriction in the House Amendment regarding the ability of carriers to use unbundled elements to provide long distance service.[769] Indeed, the House Amendment specifically states that carriers may obtain access to unbundled elements to offer "a telecommunications service," which is not limited to telephone exchange and exchange access services.[770] We observe that the Conference Committee incorporated language from the House Amendment and not the Senate Bill in describing in section 251(c)(3) the services carriers may offer using unbundled elements. Accordingly, we do not believe that the Joint Explanatory Statement's description of the provision in the Senate Bill controls our interpretation of section 251(c)(3) as enacted.

361. We also reject the argument that allowing carriers to use unbundled elements to provide originating and terminating toll services is inconsistent with the purposes of the 1996 Act. Congress intended the 1996 Act to promote competition for not only telephone exchange services and exchange access services, but also for toll services. Section 251(b)(3), for example, imposes a duty on LECs to provide dialing parity for telephone toll service.

362. We disagree with the incumbent LECs which argue that section 251(g) requires requesting carriers using unbundled elements to continue to pay federal and state access charges indefinitely. Section 251(g) provides that the federal and state equal access rules applicable before enactment, including the "receipt of compensation," will continue to apply after enactment, "until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment."[771] We believe this provision does not apply to the exchange access "services" requesting carriers may provide

[766] Joint Explanatory Statement at 117-123.

[767] *Id.* at 117.

[768] S. 652, 104th Cong., 1st Sess. § 251 (1995).

[769] Joint Explanatory Statement at 120-121.

[770] H.R. 1555, 104th Cong., 1st. Sess. § 242 (1995).

[771] 47 U.S.C. § 251(g).

themselves or others after purchasing unbundled elements. Rather, the primary purpose of section 251(g) is to preserve the right of interexchange carriers to order and receive exchange access services if such carriers elect not to obtain exchange access through their own facilities or by means of unbundled elements purchased from an incumbent.

363. We affirm our tentative conclusion in the NPRM that, telecommunications carriers purchasing unbundled network elements to provide interexchange services or exchange access services are not required to pay federal or state exchange access charges except as described in section VII, *infra*, for a temporary period. As we explained in the NPRM, if we were to require indefinitely carriers purchasing unbundled elements to also pay access charges, then incumbent LECs would receive compensation in excess of their underlying network costs. This result would be inconsistent with the pricing standard for unbundled elements set forth in section 252(d)(1).[772] In addition, we believe this conclusion is consistent with Congress's overriding goal of promoting efficient competition for local telephony services, because it will allow, in the long term, new entrants using unbundled elements to compete on the basis of the economic costs underlying the incumbent LECs' networks. The facilities used to provide exchange access services are the same as those used to provide local exchange services. We note, however, as discussed below,[773] that certain additional charges are necessary for a specific, limited duration to smooth the transition to a competitive marketplace.

364. We further conclude that when a carrier purchases a local loop for the purpose of providing interexchange services or exchange access services,[774] incumbent LECs may not recover the subscriber line charge (SLC) now paid by end users. The SLC recovers the portion of loop costs allocated to the interstate jurisdiction, but as discussed in Section II.C, *supra*, we conclude that the 1996 Act creates a new jurisdictional regime outside of the current separations process. The unbundled loop charges paid by new entrants under section 251(c)(3) will therefore recover the unseparated cost of the loop, including the interstate component now recovered through the SLC. If end users or carriers purchasing access to

[772] *See infra*, Section VII. We also note that where new entrants purchase access to unbundled network elements to provide exchange access services, whether or not they are also offering toll services through such elements, the new entrants may assess exchange access charges to IXCs originating or terminating toll calls on those elements. In these circumstances, incumbent LECs may not assess exchange access charges to such IXCs because the new entrants, rather than the incumbents, will be providing exchange access services, and to allow otherwise would permit incumbent LECs to receive compensation in excess of network costs in violation of the pricing standard in section 252(d). *See* 47 U.S.C. § 252. We further note, however, that in these same circumstances the new entrant purchasing access to an unbundled switch element must pay to the incumbent LEC the charges included in the transitional mechanism, described *infra*, at Section VII, for a temporary period.

[773] *See infra*, Section VII, discussing an interim mechanism addressing near-term access charge bypass.

[774] As discussed at *infra*, Section VIII, a different result will occur when interconnecting carriers purchase LEC retail services at wholesale rates under section 251(c)(4).

local loops were required to pay the SLC in this situation, LECs would enjoy double recovery, and the effective price of unbundled loops would exceed the cost-based levels required under section 251(d)(1).

365. Finally, we have considered the economic impact on small incumbent LECs of our conclusion that carriers purchasing access to unbundled network elements to provide interexchange or exchange access services are not required to pay federal or state access charges, except as described in Section VII, *infra,* for a temporary period. For example, the Rural Telephone Coalition argues that rural ratepayers could be subject to higher local service rates if interexchange carriers are allowed to bypass access charges through the purchase of unbundled elements before proceedings regarding access reform and universal service are completed. We reject the Rural Telephone Coalition's argument, however, because our rules, as discussed in Section VII, *infra*, provide for a limited, transitional plan to address public policy concerns raised by the bypass of access charges through unbundled network elements.

J. Specific Unbundling Requirements

366. Having interpreted the standards set forth in the 1996 Act for the unbundling of network elements, we now apply those standards to incumbent LECs' networks. Based on the information developed in this proceeding, we require incumbent LECs to provide unbundled access to local loops, network interface devices, local and tandem switching capability, interoffice transmission facilities, signaling and call-related databases, operations support systems functions, and operator services and directory assistance facilities, as described below. These network elements represent a minimum set of elements that must be unbundled by incumbent LECs. State commissions, as previously noted, are free to prescribe additional elements, and parties may agree on different or additional network elements in the voluntary negotiation process.

1. Local Loops

a. Background

367. In the NPRM, we tentatively concluded that incumbent LECs should be required to unbundle local loops. We sought comment on appropriate requirements for loop unbundling that would promote entry and build upon existing state initiatives, and whether we should adopt specific provisioning requirements for loop unbundling. We also sought comment on our tentative conclusion that incumbent LECs should make available as individual network elements various subloop elements such as the feeder, distribution, and concentration equipment.

b. Comments

368. Virtually all parties that discuss local loop unbundling support the NPRM's tentative conclusion that the local loop is a network element that should be unbundled.[775] These commenters assert that unbundling local loops is consistent with congressional intent,[776] and that doing so is technically feasible.[777] In addition, a number of state commissions note that they already require incumbent LECs to unbundle local loops.[778] In support of loop unbundling, several commenters cite ongoing unbundled loop arrangements between incumbent LECs and competing providers.[779] MFS asserts that the local loop is the most formidable entry barrier to the local exchange market and has the strongest bottleneck characteristics of any network element.[780]

369. There is disagreement, however, over how the local loop should be defined. Some commenters recommend a definition that would encompass the basic loop facilities and

[775] *See, e.g.*, Bell Atlantic comments at 22; ACTA comments at 23; LCI comments at 17; Comcast comments at 20; Matanuska Tel. at 2; ACSI comments at 35; CompTel comments at 30; Illinois Commission comments at 39; U S West comments at 47; Ameritech comments at 36; District of Columbia Commission at 23; Time Warner comments at 44-45; ALTS comments at 26; TIA comments at 9; Sprint comments at 30; NCTA comments at 37; Matanuska Tel. comments at 2; *but see* GTE comments at 33 ("there is no evident need for FCC intervention. Several states are already addressing such matters . . . Moreover, because several carriers are already providing unbundled loops pursuant to state requirements, FCC action is not necessary to assure progress by states").

[776] *See, e.g.*, Hyperion comments at 18; District of Columbia Commission comments at 23; Ameritech comments at 35; NTIA reply at 9-10; SNET comments at 22-23; MFS comments at 42; ACSI comments at 35.

[777] *See, e.g.*, Citizens Utilities comments at 15; PacTel reply at 18; New York Commission comments at 26; SBA comments at 13-14; TIA comments at 9; Texas Commission comments at 9, 17; ACSI comments at 35; NYNEX comments at 64-65; MCI comments at 29; GTE reply at 18. AT&T, for example, asserts that tariffs filed by Ameritech, SNET, NYNEX, SBC, and Bell Atlantic permit the interconnection of a competitor's switch to the incumbent LEC's loop. Letter from Betsy Brady and Bruce Cox, AT&T, to Regina Keeney, Chief, Common Carrier Bureau, FCC, Mar. 21, 1996 (AT&T March 21 Letter) at 18.

[778] *See, e.g.*, Alabama Commission comments at 18; Texas Commission comments at 17; Arizona Commission comments, Exhibit V at 8; New York Commission comments at 26; Oklahoma Commission comments, Attachment A at 13; Iowa Commission comments, Attachment B at 4.

[779] *See, e.g.*, PacTel comments at 52 (noting that it has an agreement to provide MFS with unbundled loops); Ameritech comments at 36 (by the end of 1996, over 45,000 of its unbundled loops will be used by interconnecting carriers); Frontier comments at 14 (Rochester Telephone is currently providing unbundled loops pursuant to tariff.)

[780] MFS comments at 42; *accord* MCI comments at 29; IDCMA reply at 10; Ameritech comments at 35; MECA comments at 38; CompTel comments at 30; ALTS comments at 26.

would not attempt to delineate all loop technologies.[781] Parties that favor a broad definition of local loop suggest some variation on the following: the communications path between the main distribution frame (MDF) in the central office and the network interface device (NID) at the customer premises.[782] USTA, PacTel, and BellSouth contend that such a definition complies with the 1996 Act and allows private negotiations to address the specific network architectures of incumbent LECs and the needs of the particular requesting carriers.[783]

370. Other commenters support a definition of the local loop that would require incumbent LECs to provide, where facilities exist or can be upgraded, five categories of local loops: 2-wire voice-grade analog lines, 2-wire Integrated Services Digital Network (ISDN) lines, 2-wire High-Bit-Rate Digital Subscriber Lines (HDSL), 4-wire HDSL, and 4-wire DS-1 lines.[784] These parties argue that guidance from the Commission on specific loop categories will minimize complex and resource-intensive disputes between incumbent LECs and requesting carriers by avoiding disagreements over whether a particular loop functionality qualifies as a "loop."[785] ITIC contends that the ability of new entrants to provide various digital loop functions, in competition with the incumbent LEC, is likely to stimulate entry by small entities.[786]

371. Connecticut and Texas have established different definitions of unbundled local loop functionality. The Connecticut Department of Public Utility Control has ordered SNET to unbundle 2-wire voice-grade links, 2-wire ISDN links, and 4-wire DS-1 links.[787] The Texas Commission has a similar definition, but specifically excludes DS1, DS3, and fiber loops interfacing with SONET, which the Texas Commission notes can be purchased as

[781] USTA comments at 29; U S West comments at 47; Wyoming Commission comments at 24; PacTel comments at 52-53; BellSouth comments at 37 n.82; Sprint comments at 30.

[782] U S West comments at 47; Teleport comments at 35-36; MECA comments at 28; Ameritech comments at 36; NYNEX comments at 62 n.123; Frontier comments at 14; USTA comments at 29.

[783] USTA comments at 29; PacTel comments at 52-53; BellSouth comments at 37-38.

[784] MFS comments at 43-44; GST comments at 21-22; ALTS comments at 27; *but see* Bell Atlantic reply at 10 (HDSL links are actually subloop elements and should only be available through a bona fide request process).

[785] MFS comments at 42; GST comments at 20; Intermedia comments at 10.

[786] ITIC comments at 7-8.

[787] Connecticut Commission comments, Att. B at 2.

private line services.[788] Criticizing the approach taken by the Texas Commission, ACSI and Intermedia argue that DS1 and DS3-level loops, as well as analog voice and ISDN loops, should be considered unbundled loops.[789]

372. Potential local competitors contend that an incumbent LEC should be required to modify an existing loop when a requesting carrier seeks to provide a particular type of loop capability that is not technically feasible under the loop's existing architecture.[790] MFS notes that an incumbent LEC typically will take the steps necessary to provide a particular loop functionality, such as ISDN, to a customer when that customer's existing loop is incapable of supporting the requested functionality.[791] Therefore, MFS and GST propose that the loop types available to requesting carriers should match those made available by the incumbent LEC to end-user customers within the same geographic area.[792]

373. A number of potential local competitors request that the Commission adopt specific requirements governing loop unbundling. MFS and GST recommend adoption of a rule that would establish five minutes as the standard interruption interval during which a customer's loop is disconnected from the incumbent LEC's switch and reconnected to a competitor's switch.[793] Opposing MFS's proposed five-minute loop-cutover requirement, GTE argues that the process simply may take longer than five minutes, and that the cutover interval should be addressed through negotiations.[794] Intermedia and Teleport complain that incumbent LECs have abused their control over intra-office cables that connect unbundled loops to the competitor's collocated equipment, and they ask that the Commission prohibit such practices.[795] A number of potential local competitors request that the Commission specifically require incumbent LECs to provide unbundled loops even when the LEC uses an integrated

[788] Texas Commission comments at 17-18.

[789] ACSI comments, Attachment 1 at 2-3; Intermedia comments at 10.

[790] AT&T comments at 29-30; MFS comments at 43; ALTS comments at 27; GST comments at 21.

[791] MFS comments at 43.

[792] MFS comments at 44; *accord* NYNEX comments at 64.

[793] MFS comments at 45; GST comments at 22-23.

[794] GTE reply at 18-19, n.32.

[795] Intermedia comments at 8-9; Teleport comments at 36-37.

digital loop carrier (IDLC)[796] to deliver a particular loop to the central office. These parties argue that the incumbent LEC could either move the requested loop from the IDLC to another loop carrier, or could employ demultiplexing equipment at the central office.[797]

374. *Subloop unbundling.* Commenters disagree over the Commission's tentative conclusion to identify subloop components as individual network elements. Parties that support a national subloop unbundling requirement argue that subloop unbundling is technically feasible and will enhance competition by allowing a competitor to purchase from the incumbent only those loop facilities that it cannot provide itself.[798] These parties identify the feeder, distribution, and feeder/distribution interface as the appropriate subloop elements.[799] Some parties would add to those components the network interface device, which, in most states, is the demarcation point between incumbent LECs' outside plant and customers' inside wiring.[800] AT&T and MCI contend that the feeder, FDI, and distribution segments of the local loop perform different functions and are, therefore, logically separable.[801] ACSI asserts that, just as different loop architectures have not prevented states from unbundling local loops, different subloop architectures should not prevent subloop unbundling.[802] ITIC, ITAA and Compaq assert that subloop unbundling will facilitate the

[796] An IDLC carries aggregated loop traffic from the point of concentration in the LEC's loop facilities directly into the switch via a multiplexed circuit.

[797] MFS comments at 45-46 n.58; AT&T reply at 12; GST comments at 23; MCI reply at 30.

[798] LCI comments at 17; MCI comments at 16; ACSI comments at 38-39; TCC comments at 35-37; AT&T comments at 1; Telecommunications Resellers Ass'n comments at 34; *see also* ACSI reply at 17 (ACSI plans to deploy switches and fiber rings that would replace the incumbent LEC's feeder plant, but would still need access to the incumbent LEC's loop distribution and, occasionally, loop concentration and multiplexing functionality).

[799] *See, e.g.*, ACSI comments at 36-37 AT&T comments at 19; TIA comments at 11-12; Cable & Wireless comments at 19; ACTA comments at 19; IDCMA reply at 12-13. Other carriers seek access to digital loop carriers and analog cross-connects. MCI comments at 29; ACTA comments at 29; LCI comments at 17; TCC comments at 37.

[800] *See, e.g.*, MCI comments at 16; IDCMA reply at 12; ACTA comments at 19; GCI comments at 12; LDDS comments at 41-42; MFS comments at 43 n.54; TCC comments at 36; Telecommunications Resellers Ass'n comments at 33; LCI comments at 17.

[801] AT&T comments at 19; MCI comments at 16. According to MCI, the connection is made via a patch panel, where a competitor could easily interconnect its own feeder facilities.

[802] ACSI reply at 14.

provision of high capacity loop functions and lead to innovative new data services.[803] SBA contends that subloop unbundling will facilitate entry by small businesses by allowing them to begin competing in smaller markets, and by minimizing the number of unnecessary elements they would need to purchase.[804]

375. Incumbent LECs argue that subloop unbundling is not critical for potential competitors to enter the local exchange market.[805] Bell Atlantic and GTE note that the comments of parties considered to be potential beneficiaries of subloop unbundling, such as cable operators and CAPs, express little interest in obtaining subloop elements.[806] In addition, Bell Atlantic, Ameritech, and U S West claim that every state commission that has examined the possibility of requiring subloop unbundling has rejected it.[807] Ameritech notes that no competitor has used the bona fide request process that Illinois made available over a year ago for subloop unbundling requests.[808] Ameritech also points out that MFS did not demand subloop unbundling in its recent interconnection agreement with Ameritech.[809] Rural Telephone Coalition and GVNW contend that subloop unbundling could be particularly burdensome to smaller LECs whose networks were not designed for this type of access.[810]

[803] Letter from Colleen Boothby, Levine, Blaszak, Block & Boothby (on behalf of the Information Technology Industry Council's FCC Working Group), to William F. Caton, Secretary, FCC, July 16, 1996 (ITIC July 16 *Ex Parte*); Letter from Joseph Markoski, Squire, Sanders & Dempsey (on behalf of the Information Technology Association of America) to William F. Caton, Secretary, FCC, July 22, 1996 (ITAA July 19 *Ex Parte*), Letter from Robert Stearns, Senior Vice President, Compaq Computer Corporation, to Susan Ness, Commissioner, FCC, July 23, 1996 (Compaq July 23 *Ex Parte*), Letter from Dhruv Khanna, Senior Communications Attorney, Intel Corporation, to Reed Hundt, Chairman, FCC, July 25, 1996 (Intel July 25 *Ex Parte*).

[804] SBA comments at 14.

[805] *See, e.g.*, NYNEX reply at 30; Bell Atlantic reply at 10; Ameritech comments at 17; SBC reply at 21.

[806] Bell Atlantic reply at 10; GTE reply at 19-20.

[807] Bell Atlantic comments at 24; Ameritech reply at 14-15; U S West comments at 50 n.109.

[808] Ameritech comments at 38 n.62.

[809] Ameritech reply at 17.

[810] Rural Tel. Coalition comments at 32; GVNW comments at 26-27.

376. A majority of commenters, particularly incumbent LECs, argue that subloop unbundling is best addressed in the context of specific requests by competing carriers.[811] AT&T suggests that the Commission could declare that subloop elements are network elements under section 251(c)(3), but not require them to be tariffed until the incumbent LEC receives a request for such elements.[812] Incumbent LECs also argue that subloop unbundling raises significant technical issues, and explain in detail many of the complexities involved.[813] In addition, Sprint and several incumbent LECs maintain that subloop unbundling would raise difficult administrative questions, such as the tracking, pricing, billing, maintenance and repair of subelements.[814] Various parties assert that the costs to reengineer parts of the loop and develop operational support systems for subloop elements will raise the price of subloop elements to prohibitively high levels.[815]

c. Discussion

377. We conclude that incumbent LECs must provide local loops on an unbundled basis to requesting carriers. We note that the Joint Explanatory Statement lists local loops as an example of an unbundled network element.[816] As discussed below, the record demonstrates that it is technically feasible for incumbent LECs to provide access to unbundled local loops, and that such access is critical to encouraging market entry. Further, the competitive checklist

[811] Bell Atlantic comments at 22; Mass. Commission comments at 7; Cincinnati Bell reply at 7; NTIA reply at 10; GTE comments at 34; NYNEX comments at 67-68; Ameritech comments at 41-42; USTA comments at 32; BellSouth comments at 39 n.85; Sprint comments at 32; *see also* Ameritech reply at 17 (some types of subloop unbundling may be technically feasible but are difficult to identify in the absence of specific requests).

[812] AT&T reply at 17.

[813] Letter from Sandra Wagner, Director - Federal Regulatory, SBC Communications, to William F. Caton, Acting Secretary, FCC, June 4, 1996 (SBC June 4 *Ex Parte*); *see also* PacTel reply at 18 (access at the NID would require incumbent LECs to construct a separate NID for use by the requesting carrier to preserve network security and customer privacy); Ameritech reply at 19 (NID unbundling ignores function of "overvoltage protection" provided by NID).

[814] Sprint comments at 30-31; GTE comments at 33-34; NYNEX comments at 68-69; Bell Atlantic comments at 24; U S West comments at 50-51; BellSouth comments at 39; Ameritech comments at 41.

[815] GTE comments, Attachment 1 at 1; Sprint comments at 32; U S West reply at 25; NYNEX comments at 69; *see also* Ameritech comments, Attachment 1 at 4 (service activation cost for subloop elements would be 53 percent higher than for activation of an unbundled loop).

[816] Joint Explanatory Statement at 116.

contained in section 271 requires BOCs to offer unbundled loops separate from switching as a precondition to entry into the in-region, interLATA services market.[817]

378. Requiring incumbent LECs to make available unbundled local loops will facilitate market entry and improve consumer welfare. Without access to unbundled local loops, new entrants would need to invest immediately in duplicative facilities in order to compete for customers. Such investment and building would likely delay market entry and postpone the benefits of local telephone competition for consumers. Moreover, without access to unbundled loops, new entrants would be required to make a large initial sunk investment in loop facilities before they had a customer base large enough to justify such an expenditure.[818] This would increase the risk of entry and raise the new entrant's cost of capital. By contrast, the ability of a new entrant to purchase unbundled loops from the incumbent LEC allows the new entrant to build facilities gradually, and to deploy loops for its customers where it is efficient to do so. Moreover, in some areas, the most efficient means of providing competing service may be through the use of unbundled loops. In such cases, preventing access to unbundled loops would either discourage a potential competitor from entering the market in that area, thereby denying those consumers the benefits of competition, or cause the competitor to construct unnecessarily duplicative facilities, thereby misallocating societal resources.

379. Section 251(c)(3) requires incumbent LECs to provide access to unbundled elements "at any technically feasible point."[819] The vast majority of commenters, including incumbent LECs, agree with our tentative conclusion that it is technically feasible to provide access to unbundled local loops,[820] and a number of commenters identify the main distribution frame in a LEC central office as an appropriate access point.[821] Moreover, access to unbundled loops is currently provided by several LECs pursuant to state unbundling

[817] 47 U.S.C. § 271(c)(2)(B).

[818] As of year end 1995, Class A carriers reported $268 billion of total plant in service, of which $229 billion was classified as network plant. Local loop plant comprises approximately $109 billion of total plant in service, which represents 41 percent of total plant in service and 48 percent of network plant. *See* 1995 ARMIS Report 43-04.

[819] 47 U.S.C. § 251(c)(3).

[820] *See, e.g.*, PacTel reply at 18; New York Commission comments at 26; SBA comments at 13-14; TIA comments at 9; GTE reply at 18; NYNEX comments at 64-65.

[821] *See, e.g.*, Bell Atlantic comments, Albers Attachment at 6-8; Ameritech comments at 36.

requirements.[822] Thus, we conclude that it is technically feasible for incumbent LECs to provide access to unbundled local loops at, for example, a central office distribution frame.

380. We further conclude that the local loop element should be defined as a transmission facility between a distribution frame, or its equivalent, in an incumbent LEC central office, and the network interface device at the customer premises. This definition includes, for example, two-wire and four-wire analog voice-grade loops, and two-wire and four-wire loops that are conditioned to transmit the digital signals needed to provide services such as ISDN, ADSL, HDSL, and DS1-level signals.[823] We note that a number of parties proposed definitions of the local loop that encompassed some or all of these loop types.[824] In addition, we agree with ITIC that the ability to offer various digital loop functions in competition with incumbent LECs may be particularly beneficial to small entities by allowing them to serve niche markets.[825]

381. Incumbent LECs are required to provide access to these transmission facilities only to the extent technically feasible. That is, if it is not technically feasible to condition a loop facility to support a particular functionality, the incumbent LEC need not provide unbundled access to that loop so conditioned. For example, a local loop that exceeds the maximum length allowable for the provision of a high-bit-rate digital service could not feasibly be conditioned for such service.[826] Such a situation may necessitate a request for subloop elements.[827] Nevertheless, section 251(c)(3) does not limit the types of

[822] *See, e.g.*, Ameritech comments at 36 (by the end of 1996, over 45,000 of its unbundled loops will be used by interconnecting carriers); Frontier comments at 14 (Rochester Telephone is currently providing unbundled loops pursuant to tariff); *see also* Alabama Commission Comments at 18; Texas Commission comments at 17; New York Commission comments at 26; Arizona Commission comments, Exh. V at 8.

[823] ISDN (Integrated Services Digital Network) at the Basic Rate Interface level permits the transmission of digital signals over the loop at the rate of 144 kbps, which provides two standard 64 kbps voice or data channels and a 16 kbps data channel. ISDN at the Primary Rate Interface permits 23 standard 64 kbps channels plus one 16 kbps data channel. ADSL (Asynchronous Digital Subscriber Line) is a transmission path that facilitates 6 Mbps digital signal downstream and 640 kbps digital signal upstream, while simultaneously carrying an analog voice signal. Two-wire HDSL (High-bit-rate Digital Subscriber Line) permits the transmission of a 768 kbps digital signal over a copper loop, while four-wire HDSL allows the transmission of 1.544 Mbps over two two-wire pairs.

[824] *See, e.g.*, MFS comments at 43-44; ALTS comments at 27; GST comments at 21-22; ACSI comments, Att. 1 at 2.

[825] ITIC comments at 7-8.

[826] Such loop conditioning may involve removing load coils or bridged taps that interfere with the transmission of digital signals.

[827] *See, e.g.*, Bell Atlantic reply at 10 n.11.

telecommunications services that competitors may provide over unbundled elements to those offered by the incumbent LEC.

382. Our definition of loops will in some instances require the incumbent LEC to take affirmative steps to condition existing loop facilities to enable requesting carriers to provide services not currently provided over such facilities. For example, if a competitor seeks to provide a digital loop functionality, such as ADSL, and the loop is not currently conditioned to carry digital signals, but it is technically feasible to condition the facility, the incumbent LEC must condition the loop to permit the transmission of digital signals. Thus, we reject BellSouth's position that requesting carriers "take the LEC networks as they find them" with respect to unbundled network elements.[828] As discussed above, some modification of incumbent LEC facilities, such as loop conditioning, is encompassed within the duty imposed by section 251(c)(3).[829] The requesting carrier would, however, bear the cost of compensating the incumbent LEC for such conditioning.[830]

383. We further conclude that incumbent LECs must provide competitors with access to unbundled loops regardless of whether the incumbent LEC uses integrated digital loop carrier technology, or similar remote concentration devices, for the particular loop sought by the competitor. IDLC technology allows a carrier to aggregate and multiplex loop traffic at a remote concentration point and to deliver that multiplexed traffic directly into the switch without first demultiplexing the individual loops. If we did not require incumbent LECs to unbundle IDLC-delivered loops, end users served by such technologies would not have the same choice of competing providers as end users served by other loop types. Further, such an exception would encourage incumbent LECs to "hide" loops from competitors through the use of IDLC technology.

384. We find that it is technically feasible to unbundle IDLC-delivered loops. One way to unbundle an individual loop from an IDLC is to use a demultiplexer to separate the unbundled loop(s) prior to connecting the remaining loops to the switch. Commenters identify a number of other methods for separating out individual loops from IDLC facilities,

[828] BellSouth comments at 39.

[829] *See supra* Section IV.D., interpreting the term "technically feasible." *See also* MFS comments at 43 (arguing that incumbent LECs condition loops in order to provide particular digital loop functionalities to their customers).

[830] *See supra* Section VII, discussing the recovery of costs under section 252(d)(1).

including methods that do not require demultiplexing.[831] Again, the costs associated with these mechanisms will be recovered from requesting carriers.

385. We decline to define a loop element in functional terms, rather than in terms of the facility itself. Some parties advocate defining a loop element as merely a functional piece of a shared facility, similar to capacity purchased on a shared transport trunk.[832] According to these parties, this definition would enable an IXC to purchase a loop element solely for purposes of providing interexchange service. While such a definition, based on the types of traffic provided over a facility, may allow for the separation of costs for a facility dedicated to one end user, we conclude that such treatment is inappropriate. Giving competing providers exclusive control over network facilities dedicated to particular end users provides such carriers the maximum flexibility to offer new services to such end users. In contrast, a definition of a loop element that allows simultaneous access to the loop facility would preclude the provision of certain services in favor of others. For example, carriers wishing to provide solely voice-grade service over a loop would preclude another carrier's provision of a digital service, such as ISDN or ADSL, over that same loop.[833] We note that these two types of services could be provided by different carriers over, for example, separate two-wire loop elements to the same end user.

386. Incumbent LECs must provide cross-connect facilities, for example, between an unbundled loop and a requesting carrier's collocated equipment, in order to provide access to that loop. As we conclude in section IV.D, above, an incumbent LEC must take the steps necessary to allow a competitor to combine its own facilities with the incumbent LEC's unbundled network elements. We highlight this requirement for unbundled loops because of allegations by competitive providers that incumbent LECs have imposed unreasonable rates, terms, and conditions for such cross-connect facilities in the past.[834] Incumbent LECs may recover the cost of providing such facilities in accordance with our rules on the costs of interconnection and unbundling. Charges for all such facilities must meet the cost-based standard provided in section 252(d)(1), and the terms and conditions of providing these facilities must be reasonable and nondiscriminatory under section 251(c)(3).

[831] Under more recent standards for IDLC facilities, a competitor's loop traffic could be separated from the incumbent LEC's loop traffic without the use of multiplexers. *See, e.g.*, MCI comments at 30 (IDLC loops can be moved onto other loop carrier links, or alternatively, can be removed from the mulitiplexed signal through "hair pinning").

[832] *See, e.g.*, Cable & Wireless comments at 26-27; ACTA comments at 17.

[833] Digital services such as ISDN and ADSL occupy the same frequency spectrum on a loop as ordinary voice-grade services.

[834] Intermedia comments at 8-9; Teleport comments at 36-37.

387. At this time, we decline to adopt additional terms and conditions, such as the five-minute loop cutover requirement proposed by MFS, for loop provisioning. We agree with commenters who contend that the provisioning of unbundled local loops must be subject to close scrutiny to ensure that incumbent LECs do not delay loop cutover or otherwise complicate the acquisition of loops by a competitor. We conclude, however, that the rules we adopt in the Access to Unbundled Network Elements section that require nondiscriminatory terms and conditions for provisioning, billing, testing, and repair of unbundled elements, and the availability of electronic ordering systems, adequately address these concerns. We will continue to review and revise our rules in this area as necessary.

388. Section 251(d)(2)(A) requires the Commission to consider whether "access to such network elements as are proprietary in nature is necessary."[835] Most parties did not identify any proprietary concerns associated with providing unbundled access to local loops. Ericsson notes that some "active" loop equipment, such as channel banks and remote terminal equipment, is often proprietary in nature, and that manufacturers would require time to modify such equipment to create end-to-end network compatibility on a national basis.[836] Ericsson does not contend, however, that any proprietary information would be revealed if loops using such equipment were unbundled, or that use of such equipment should prevent loop unbundling in general.[837] Thus, we conclude that loop elements are, in general, not proprietary in nature under our interpretation of section 251(d)(2)(A). Even if loop elements were proprietary in nature, however, Ericsson does not meet the second consideration in our section 251(d)(2)(A) standard, which requires a showing that a new entrant can offer the proposed telecommunications service through the use of other, nonproprietary elements in the incumbent LEC's network.[838] Ericsson merely contends that manufacturers may need time to establish compatibility between its proprietary equipment and equipment of other manufacturers.[839] Therefore, we find that Ericsson's concerns do not justify withholding unbundled loops from requesting carriers pursuant to section 251(d)(2)(A).

389. Section 251(d)(2)(B) directs the Commission to consider whether "the failure to provide access to such network elements would impair the ability of the telecommunications

[835] 47 U.S.C. § 251(d)(2)(A).

[836] Ericsson comments at 4.

[837] Ericsson's comments were in response to a question in the NPRM seeking comment on the need to accommodate new loop technologies or services. Ericsson comments at 4.

[838] *See supra* Section V.E.3.

[839] Ericsson comments at 4-5.

carrier seeking access to provide the services that it seeks to offer."[840] We have interpreted the term "impair" to mean either increased cost or decreased service quality that would result from using network elements of the incumbent LEC other than the one sought.[841] Commenters do not identify alternative facilities that would fulfill requesting carriers' need for transmission between the central office and the customer premises at the same cost and same quality of service. Accordingly, we conclude that competitors' ability to provide telephone exchange, exchange access, or other telecommunications services would be significantly impaired if they did not have the opportunity to purchase unbundled loops from incumbent LECs.

390. As a general matter, we believe that subloop unbundling could give competitors flexibility in deploying some portions of loop facilities, while relying on the incumbent LEC's facilities where convenient. For example, a competitor may seek to minimize its reliance on the LEC's facilities by combining its own feeder plant with the incumbent LEC's distribution plant.[842] In addition, some high bandwidth services, such as ADSL, cannot be provided over long loop lengths. ITIC, Compaq, and Intel assert that subloop unbundling would lead to innovative new data services.[843] In these situations, carriers would need access at points along the loop closer to the customer premises. The record presents evidence primarily of logistical, rather than technical, impediments to subloop unbundling.[844] Several LECs and USTA, for example, assert that incumbent LECs would need to create databases for identifying, provisioning, and billing for subloop elements.[845] Further, incumbent LECs argue that there is

[840] 47 U.S.C. § 251(d)(2)(B).

[841] *See supra* Section V.E.3.

[842] Subloop unbundling could have network efficiency advantages as well. One party notes that subloop unbundling could allow packetized data traffic to be shifted to a data network, rather than flowing through the circuit-switched network portions of the public switched network. *See* ITIC July 16 *Ex Parte*.

[843] ITIC July 16 *Ex Parte*, ITAA July 22 *Ex Parte*, Compaq July 23 *Ex Parte*, Intel July 25 *Ex Parte*. ITAA contends that subloop unbundling would allow data and other traffic to be routed before it reaches an incumbent LEC's central office switch. According to ITAA, such routing would moot incumbent LECs' argument that traffic from the Internet and other on-line services is negatively impacting their switches. ITAA July 19 *Ex Parte*.

[844] *See, e.g.*, Sprint comments at 30-31; GTE comments at 33-34; NYNEX comments at 68-69; Bell Atlantic comments at 24 (all discussing a variety of tracking, billing, and maintenance issues that would be raised by subloop unbundling).

[845] USTA comments at 31; NYNEX comments at 69; Ameritech comments at 41; BellSouth comments at 39; U S West comments at 50.

insufficient space at certain possible subloop interconnection points.[846] We note that these concerns do not represent "technical" considerations under our interpretation of the term "technically feasible."[847]

391. Nonetheless, we decline at this time to identify the feeder, feeder/distribution interface (FDI), and distribution components of the loop as individual network elements. We find that proponents of subloop unbundling do not address certain technical issues raised by incumbent LECs concerning subloop unbundling. Incumbent LECs contend that access by a competitor's personnel to loop equipment necessary to provide subloop elements, such as the FDI, raise network reliability concerns for customers served through that FDI.[848] SBC, for example, asserts that access to its loop concentration points by competitors would increase the risk of error by a competitor's technicians that may disrupt service to customers of one or both carriers.[849] U S West contends that the potential for poor technical implementation of subloop interconnection and the lack of overall responsibility for loop performance is very likely to degrade overall service quality.[850] Proponents of subloop unbundling do not adequately respond to these arguments by incumbent LECs. As discussed above, we have determined that we must take into account specific, demonstrable claims regarding network reliability in determining whether to identify any particular component as an element that must be unbundled. Therefore, we believe that, at this stage, based on the current record evidence, the technical feasibility of subloop unbundling is best addressed at the state level on a case-by-case basis at this time.[851] Information developed by the parties in the context of a specific request for subloop unbundling will provide a useful framework for addressing the loop maintenance and network reliability matters that we have identified. Based on actions taken by the states or other future developments, and on the importance of subloop unbundling in light of technological advancements, we intend to revisit the specific issue of subloop unbundling sometime in 1997.

[846] Bell Atlantic comments at 24; SBC comments at 38; NYNEX comments at 66.

[847] *See supra* Section IV.D.

[848] BellSouth comments at 39; NYNEX comments at 66; SBC comments at 39; U S West comments at 52 n.113; PacTel comments at 18.

[849] SBC comments at 39.

[850] U S West comments at 52 n.113.

[851] We encourage states to pursue subloop unbundling in response to requests for subloop elements by competing providers.

392. We require incumbent LECs to offer unbundled access to the network interface device (NID),[852] as a network element, as described below. When a competitor deploys its own loops, the competitor must be able to connect its loops to customers' inside wiring in order to provide competing service, especially in multi-tenant buildings. In many cases, inside wiring is connected to the incumbent LEC's loop plant at the NID. In order to provide service, a competitor must have access to this facility. Therefore, we conclude that a requesting carrier is entitled to connect its loops, via its own NID, to the incumbent LEC's NID.[853]

393. Pursuant to section 251(c)(3), we find that this arrangement clearly is technically feasible. Ameritech notes that it currently maintains such connections with competitors that have deployed their own loop facilities.[854] This is persuasive evidence that unbundled access at the NID, in this manner, does not raise network reliability concerns. Under section 251(d)(2)(A), the record contains no evidence of proprietary concerns with unbundled access to the NID. In addition, under our interpretation of the "impair" test of section 251(d)(2)(B), commenters do not contend that new entrants could obtain the same functionality at the same cost and service quality through other network elements of the incumbent LEC. Moreover, the record indicates that certain network architectures used by new entrants, such as fiber rings, can most efficiently connect end users to the new entrant's switching office without use of the incumbent LEC's facilities.[855] Thus, we conclude that the unavailability of access to incumbent LECs' NIDs would impair the ability of carriers deploying their own loops to provide service. Further, we believe that unbundled access to the NID will facilitate entry strategies premised on the deployment of loops. As discussed in section VII, above, the new entrant bears the costs of connecting its NID to the incumbent LEC's NID.

394. We do not require an incumbent LEC to permit a new entrant to connect its loops directly to the incumbent LEC's NID. MCI contends that directly connecting its loops to incumbent LECs' NIDs is "[t]he only practical solution" for gaining access to inside

[852] The NID is a cross-connect device used to connect loop facilities to inside wiring.

[853] We emphasize that access to inside wiring through the incumbent LEC's NID does not entitle a competitor to deliver its loop facilities into a building without the permission of the building owner. Similarly, access to an incumbent LEC's NID does not entitle the competitor to the riser and lateral cables between the NID and individual units within the building, which may be owned or controlled, for example, by the premises owner.

[854] Letter from James K. Smith, Director-Federal Relations, Ameritech, to William F. Caton, Acting Secretary, FCC, July 15, 1996 (Ameritech July 15 *Ex Parte*).

[855] Letter from Don Sussman, MCI, to William F. Caton, FCC, July 12, 1996 (MCI July 12 *Ex Parte*).

wiring.[856] According to MCI, there is no extra wiring to connect the incumbent LEC's NID to the new entrant's NID.[857] Ameritech demonstrates, however, that it currently provides access to inside wiring through the type of arrangement that MCI asserts is not practical -- that is, by connecting a new entrant's loops to inside wiring via the new entrant's NID and Ameritech's NID. MCI does not demonstrate that its ability to provide competing service is unreasonably limited by the arrangements explained by Ameritech.

395. The record contains conflicting evidence on the technical feasibility of requiring incumbent LECs to permit competitors to connect their loops directly to incumbent LECs' NIDs. Ameritech asserts that such a direct connection would leave Ameritech's unused loops without overvoltage protection.[858] MCI argues that overvoltage protection is provided through the incumbent LEC's "protector module" that is separate from the NID.[859] Ameritech responds that its NIDs are integrated units providing both overvoltage protection and a demarcation point, and that these two functions of the NID are "inseverable."[860] AT&T contends direct access to incumbent LECs NIDs is technically feasible. According to AT&T, if a competitor connects its loops directly to the incumbent LEC's NID, the incumbent LEC's loops remain connected to the grounding equipment that protects against overvoltage.[861] According to AT&T, when the competitor does not use spare terminals on the NID, the competitor would be required to ground the incumbent LEC's unused loops to protect against overvoltage.[862]

396. We find that the record in this proceeding does not permit a determination on the technical feasibility of the direct connection of a competitor's loops to the incumbent LEC's NID. Our requirement of a NID-to-NID connection addresses the most critical need of competitors that deploy their own loops -- obtaining access to the inside wiring of the

[856] MCI July 12 *Ex Parte* at 6.

[857] *Id.* at 5.

[858] Ameritech July 15 *Ex Parte* at 5.

[859] Letter from Donald Evans, Vice President - Federal Regulatory Affairs, MCI, to William F. Caton, Secretary, FCC, July 16, 1995 (MCI July 16 *Ex Parte*).

[860] Letter from James Smith, Director-Federal Relations, Ameritech, to William F. Caton, Acting Secretary, FCC, July 24, 1996 (Ameritech July 24 *Ex Parte*).

[861] Letter from Bruce Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, July 18, 1996 (AT&T July 18 *Ex Parte*).

[862] *Id.*

building. We recognize, however, that competitors may benefit by directly connecting their loops to the incumbent LEC's NID, for example, by avoiding the cost of deploying NIDs.[863] States should determine whether direct connection to the NID can be achieved in a technically feasible manner in the context of specific requests by competitors for direct access to incumbent LECs' NIDs.[864]

2. Switching Capability

a. Background

397. In the NPRM, we tentatively concluded that incumbent LECs should be required to make available local switching capability as an unbundled network element. We sought comment on how a local switching element should be defined, and we identified two possible models: the switch "platform" approach, which would entitle and require a requesting carrier to purchase all of the features and functions of the switch on a per-line basis and the port approach used by the New York Commission, which offers local switching capability through the purchase of a port at a retail rate. We also sought comment on other definitions of a local switching element. In addition, we requested that commenters address whether vertical switching functions, such as those enabling the provision of custom local area signaling service (CLASS) features and call waiting, should be considered individual network elements separate from the basic switching functionality.

b. Comments

398. The vast majority of commenters support the Commission's tentative conclusion that local switching should be an unbundled network element.[865] Such parties note that the section 271 competitive checklist includes unbundled local switching and the legislative history of the 1996 Act identifies local switching as a possible element.[866] Several potential

[863] *Id.* at 1.

[864] Ameritech July 15 *Ex Parte* at 5-6.

[865] *See, e.g.*, GCI comments at 12; TIA comments at 11-12; Citizens Utilities comments at 15; Intermedia comments at 13; Bay Springs, *et al.* comments at 18; Wyoming Commission comments at 22.

[866] *See, e.g.*, Ameritech comments at 43; LDDS comments at 44; USTA comments at 32; BellSouth comments at 40.

local competitors contend that unbundled local switching functionality is very important to promote entry into the local exchange market.[867]

399. Some incumbent LECs support a definition of local switching as a switching port.[868] These LECs favor a definition of a port that focuses on *providing access* to additional switching features, rather than on the switching features themselves.[869] PacTel, for example, asserts that a port provides dialtone and a telephone number, but does not include local usage or vertical features such as custom calling.[870] Bell Atlantic contends that the 1996 Act requires incumbent LECs to *provide access* to unbundled network elements, and that a switch port meets this directive by providing access to the switch.[871]

400. Sprint, USTA, SBC, NYNEX, and MECA, on the other hand, favor a definition of the unbundled local switching element that includes the basic function of connecting network access lines to other lines or trunks.[872] These parties would expressly exclude from this local switching definition vertical features such as custom calling.[873] Sprint and SBC argue that vertical features are retail services offered to end users today, and therefore, must be purchased by the competitor under the wholesale rate provisions of the Act.[874] USTA

[867] LDDS reply at 18; TIA comments at 18; AT&T March 21 Letter 18 at 17-18; *but see* SBC reply at 23 ("Given that 'high margin' services are made possible through the switch, new entrants will likely purchase their own switching facilities.").

[868] BellSouth comments at 41; Cincinnati Bell comments at 18; U S West comments at 54-55; Bell Atlantic comments at 25; GTE comments at 37.

[869] BellSouth comments at 41; Cincinnati Bell comments at 18; USTA comments at 33; U S West comments at 54-55; Bell Atlantic comments at 25; GTE comments at 37; NYNEX comments at 69-70.

[870] PacTel comments at 55 (local usage should be excluded from the definition of a port because it is a tariffed service and should therefore be available to requesting carriers only through resale); *see also* SBC comments at 43 (the port should be separate from the switch).

[871] Bell Atlantic reply at 12.

[872] Sprint comments at 34; USTA reply at 16-17; SBC reply at 20; NYNEX reply at 31; MECA comments at 29.

[873] Sprint comments at 36; USTA reply at 16; SBC reply at 20; MECA comments at 29. Examples of vertical features include call waiting and three-way calling, which are custom calling features, and caller ID and call forwarding, which are custom local area signaling service (CLASS) features that rely on the transmission of signaling information between the calling and called parties.

[874] USTA reply at 16-17; PacTel reply at 19; SBC reply at 21; *see also* Sprint comments at 37-38 (although it is not technically feasible to unbundle vertical services, the costs of such services can be identified and should be excluded from the charge for the local switching element).

suggests that this approach best comports with the Act and is a reasonable compromise between the more limited port approach and the switching platform proposal.[875]

401. A number of commenters support a definition of the local switch that has been referred to as the "local switching platform."[876] These parties recommend defining the local switching element as encompassing all functions performed by the local switch, including basic switching functionality and vertical features.[877] Supporters of the switching platform approach contend that, because the requesting carrier would pay for all local switching functionality on a per-line basis, it would have the incentive and ability to combine features and services more effectively than it would under more limited definitions of the local switching element.[878]

402. LDDS and AT&T argue that the switch platform approach is more consistent with the Act than the port approach. These carriers argue that, under the port approach, local switching has not been "unbundled" because a competitor cannot combine a port with loop and trunking facilities to provide telephone service. Instead, the competitor must also purchase basic switching functionality from the incumbent LEC at wholesale rates.[879] According to AT&T and LDDS, the switching platform does not raise technical feasibility problems because requesting carriers would not have direct access to the switching hardware or software. Instead, the requesting carrier would "designate" the features to be associated with its own lines and the routing of its customers' calls, and the incumbent LEC would actually perform that function.[880]

[875] USTA reply at 16.

[876] MCI comments at 30-32; AT&T comments at 20-21; LDDS comments at 44-46; Texas Commission reply at 8; TCC comments at 37-38; ACTA comments at 18-20; ACSI comments at 40-41; CompTel comments at 33-35; Ad Hoc Telecommunications Users Committee reply at 8.

[877] Functions listed by proponents of the switch platform include local usage, exchange access, access to operators, announcements, recognition of customer requests for service, obtaining call-specific information, data analysis, selection of traffic routes, call signaling, recording for billing and network management, tests required for network maintenance and call processing, custom calling features (*e.g.* call forwarding, call waiting), and CLASS features (*e.g.* caller ID, call return). LDDS comments at 44; ACSI comments at 40-41; MCI comments at 30. AT&T and LDDS also propose to include in the local switching definition Centrex, carrier identification code determination, and access to databases and adjunct processors for the purpose of offering advanced intelligent network (AIN) services. LDDS comments at 45; AT&T Mar. 21 Letter at 18.

[878] LDDS comments at 45; AT&T comments at 21.

[879] LDDS comments at 55; AT&T reply at 18. The Texas Commission notes that Ameritech's unbundled port tariffs in Illinois expressly exclude basic switching functionality. Texas Commission comments at 13-14.

[880] AT&T reply at 19; LDDS reply at 19.

403. Opponents of the local switching platform assert that implementing a switch platform would cause technical problems. U S West and GVNW argue that the only technically feasible way to implement the switching platform would be physically to partition the switch which, according to U S West, would greatly reduce the switch's efficiency.[881] AT&T characterizes this argument as frivolous and asserts that physical partitioning of the switch has not been proposed by any party.[882] NYNEX contends that incumbent LECs would need to add capacity to their switches to accommodate competitors' demand for switch platforms.[883] AT&T responds that, because the requesting carrier is likely to be serving former customers of the incumbent LEC, the switching resources needed by the incumbent and competitor, at least initially, are likely to balance out.[884] GTE, U S West, and USTA also argue that the switching platform approach would discourage incumbent LECs from upgrading their switches because all new features would be immediately available to competitors at a discounted rate.[885]

404. Incumbent LECs argue that the switch platform would allow a requesting carrier to circumvent the statutory scheme that requires incumbent LECs to offer local exchange service at wholesale rates for resale by requesting carriers.[886] These commenters also contend that vertical features, such as custom calling and call waiting, are retail services, not network elements, and should be obtained by requesting carriers pursuant to section 251(c)(4).[887] Ad Hoc Telecommunications Users maintains that the switch platform approach raises entry costs by forcing competitive providers to purchase switching functions they may never need or use.[888] MCI and TCC contend that the local switching element should specifically include vertical features such as CLASS features and custom calling because incumbent LECs do not

[881] U S West comments at 55.

[882] AT&T reply at 19.

[883] NYNEX reply at 32.

[884] Letter from Bruce Cox, Government Affairs Director, AT&T, to William Caton, Secretary, FCC, June 28, 1996 (AT&T June 28 *Ex Parte*).

[885] GTE comments at 38; SBC comments at 43; USTA reply at 17.

[886] PacTel comments at 54; Bell Atlantic comments at 26; GTE reply at 20; *see also* Sprint comments at 38 (the local switching platform does not create incentives for competitors to build out facilities).

[887] USTA comments at 34-35; Cincinnati Bell comments at 18.

[888] Ad Hoc Telecommunications Users Committee comments at 23.

incur the costs for these services on a usage basis.[889] ACSI and LCI also support the availability of vertical switching functionalities on an unbundled basis.[890]

405. Incumbent LECs contend that the switch platform approach is impractical because standard measures of switching, such as the number of line or trunk terminations, would not capture the dynamic nature of switching.[891] In response, MCI and LDDS state that a requesting carrier would commit to purchasing a minimum level of trunk port capacity and a minimum level of busy hour switch capacity for at least one year.[892] Several BOCs and Sprint contend that the Commission should not adopt the switch platform because there is insufficient understanding of what it would entail.[893]

406. Most parties support the Commission's proposal to require incumbent LECs to unbundle tandem switching as a network element.[894] AT&T notes that the availability of unbundled tandem switches is critical to the connection of its own switches to incumbent LECs' switches.[895] AT&T argues that unbundled tandem switching is technically feasible because IXCs currently interconnect with incumbent LECs' tandem switches through standard specifications.[896] Other commenters indicate that tandem switching is available today through access tariffs, and therefore it is unnecessary for the Commission to unbundle tandem switching.[897] SBC states that the Commission should not apply the same unbundling

[889] MCI comments at 31; TCC comments at 31.

[890] ACSI comments at 41; LCI comments at 18.

[891] USTA comments at 34; MECA comments at 30.

[892] MCI comments at 30; LDDS comments at 44-45.

[893] Ameritech comments at 45; SBC comments at 42; Bell Atlantic reply at 11; Sprint comments at 39; NYNEX reply at 31.

[894] *See, e.g.*, AT&T comments at 22; New York Commission comments at 27; U S West comments at 48; MCI comments at 17; Competition Policy Institute comments at 16; GST comments at 24; TIA comments at 13.

[895] AT&T Mar. 21 Letter at 21.

[896] AT&T comments at 22; ALTS comments at 30.

[897] Bell Atlantic comments at 27; TIA comments at 13.

requirements for tandem and end office switches because tandem switches only offer trunk interfaces and do not contain switching features on a per-line basis.[898]

407. AT&T, MCI, and TCC also ask that the local switching element be defined to include data switching by packet switches.[899] MCI asserts that it is technically feasible for the requesting carrier's own facilities to interface with an incumbent LEC's packet switch through a connection at a DS1 frame or patch panel.[900] PacTel supports the unbundling of data switches as network elements.[901]

408. Several potential local competitors argue that the Commission should require incumbent LECs, in providing unbundled local switching, to enable requesting carriers to designate the trunk assignment for its local exchange customers.[902] CompTel states that this would maximize competitors' ability to create new services.[903] PacTel argues that it is not technically feasible to route local calls originating on unbundled loops onto particular outgoing trunks connected to that switch.[904]

409. ALTS argues that incumbent LECs should be required to make local switching available so that all signaling information necessary to complete a call is passed to the connecting carrier, such as an IXC or a competing provider.[905] The Wyoming Commission is considering adoption of a rule that would require incumbent LECs to pass on signaling

[898] SBC comments at 34 n.67.

[899] AT&T comments at 20; TCC comments at 39; MCI comments at 18.

[900] MCI comments at 18.

[901] PacTel reply at 21.

[902] ALTS comments, Attachment A at 20-21; LCI comments at 18; TCC reply at 17; *see also* CompTel comments at 34 (the Commission should enable requesting carriers to establish routing parameters for the following categories of traffic: domestic interLATA, presubscribed intraLATA, non-presubscribed intraLATA, 800/888, 900, interLATA operator traffic, intraLATA/0-/0+ operator traffic, and international direct dialed).

[903] CompTel comments at 34.

[904] PacTel reply at 20.

[905] ALTS comments at 29 (claiming that some carriers strip certain signaling information and end offices and tandem offices, thereby undermining the ability of new entrants to receive and aggregate traffic for various IXCs).

information to interconnected carriers, and would also prohibit incumbent LECs from claiming a proprietary right to signaling protocols.[906]

c. Discussion

(1) Local Switching Capability

410. We conclude that incumbent LECs must provide local switching as an unbundled network element. The record supports a finding that it is technically feasible for incumbent LECs to provide access to an unbundled local switching element, and that denying access to a local switching element would substantially impair the ability of many competing carriers to provide switched telecommunications services. We also note that section 271 requires BOCs to offer or provide "[l]ocal switching unbundled from transport, local loop transmission, or other services" as a precondition to providing in-region interLATA services.[907] As discussed below, we identify a local switching element that includes the basic function of connecting lines and trunks as well as vertical switching features, such as custom calling and CLASS features.[908] We agree with the Illinois Commission that defining the switching element in this way will permit competitors to compete more effectively by designing new packages and pricing plans.[909]

411. In the United States, there are over 23,000 central office switches, the vast majority of which are operated by incumbent LECs.[910] It is unlikely that consumers would receive the benefits of competition quickly if new entrants were required to replicate even a small percentage of incumbent LECs' existing switches prior to entering the market. The Illinois Commission staff presented evidence in a recent proceeding indicating that it takes

---

[906] Wyoming Commission comments at 24.

[907] 47 U.S.C. § 271(c)(2)(B)(vi).

[908] Custom calling features, such as call waiting, three-way calling, and call forwarding, are switch-based calling functions. CLASS features, such as caller ID, are number translation services that are based on the availability of interoffice signaling.

[909] *AT&T Communications of Illinois, Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act*, Order, Docket Nos. 95-0458 and 95-0531, June 26, 1996 (Illinois Wholesale Order) at 63-66.

[910] *Statistics of Communications Common Carriers*, Federal Communications Commission, 1994/1995 Edition, at Table 2.4. This figure is derived from carriers filing with the FCC, which represent approximately 92 percent of the industry.

between nine months and two years for a carrier to purchase and install a switch.[911] We find this to be persuasive evidence of the entry barrier that would be created if new entrants were unable to obtain unbundled local switching from the incumbent LEC. The ability to purchase unbundled switching will also promote competition in an area until the new entrant has built up a sufficient customer base to justify investing in its own switch. We expect that the availability of unbundled local switching is likely to increase the number of carriers that will successfully enter the market, and thus should accelerate the development of local competition.

412. We define the local switching element to encompass line-side and trunk-side facilities plus the features, functions, and capabilities of the switch.[912] The line-side facilities include the connection between a loop termination at, for example, a main distribution frame (MDF), and a switch line card.[913] Trunk-side facilities include the connection between, for example, trunk termination at a trunk-side cross-connect panel and a trunk card. The "features, functions, and capabilities" of the local switch include the basic switching function of connecting lines to lines, lines to trunks, trunks to lines, trunks to trunks. It also includes the same basic capabilities that are available to the incumbent LEC's customers, such as a telephone number, directory listing, dial tone, signaling, and access to 911, operator services, and directory assistance.[914] In addition, the local switching element includes all vertical features that the switch is capable of providing, including custom calling, CLASS features, and Centrex, as well as any technically feasible customized routing functions. Thus, when a requesting carrier purchases the unbundled local switching element, it obtains all switching features in a single element on a per-line basis. A requesting carrier will deploy individual vertical features on its customers' lines by designating, via an electronic ordering interface, which features the incumbent LEC is to activate for particular customer lines.

---

[911] Supplemental Rebuttal Testimony of Jake Jennings, Office of Policy and Planning, Illinois Commerce Commission, ICC Staff Ex. 1.04, Docket No. 95-0458, at 11-12 (Mar. 11, 1996).

[912] The NPRM used the terms "switch platform" and "port," as they had been developed by the Illinois and New York Commissions, respectively, to describe two possible approaches to establishing an unbundled local switching element. Parties commenting on the unbundled switching element attributed a variety of functionalities to each of these terms. To avoid confusion, we will not use these terms in discussing the unbundled local switching element. Instead, we will address commenters' proposals according to the functionality that they recommend be included in the definition of an unbundled local switching element.

[913] A line card is a plug-in electronic printed circuit card that operates ringing, holding, and other features associated with one or several telephone lines.

[914] Purchasing the local switching element does not entitle a requesting carrier to connect its own AIN call processing database to the incumbent LEC's switch, either directly or via the incumbent LEC's signal transfer point or database. Section V.I.4, which discusses the unbundling of incumbent LECs' signaling systems and databases. We also note that E911 and operator services are further unbundled from local switching. *See infra* Section V.I.6.

413. We disagree with commenters who argue that vertical switching features should be classified exclusively as retail services, available to competing providers only through the resale provision of section 251(c)(4).[915] The 1996 Act defines network element as "a facility or equipment used in the provision of a telecommunications service" and "the features, functions, and capabilities that are provided by means of such facility or equipment."[916] Vertical switching features, such as call waiting, are provided through operation of hardware and software comprising the "facility" that is the switch, and thus are "features" and "functions" of the switch.[917] We note that the Illinois Commission recently defined an unbundled local switching element to include vertical switching features.[918] Although we find that vertical switching features should be available to competitors through the resale provision of section 251(c)(4), we reject the view that Congress intended for section 251(c)(4) implicitly to remove vertical switching features from the definition of "network element."[919] Therefore, we find that vertical switching features are part of the unbundled local switching element.[920]

414. At this time we decline to require further unbundling of the local switch into a basic switching element and independent vertical feature elements. Such unbundling does not appear to be necessary to promote local competition. Indeed, most potential local competitors do not recommend that vertical switching features be available as separate network elements. MCI, AT&T and LDDS believe that such features should be available to new entrants as part of the local switching element.[921] We also note that additional unbundling of the local switch would not result in a practical difference in the way the local switching element is provisioned. As discussed below, when a competing provider orders the unbundled basic switching element for a particular customer line, it will designate which vertical features

[915] Section 251(c)(4)(A) requires incumbent LECs "to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers." 47 U.S.C. § 251(c)(4)(A).

[916] 47 U.S.C. § 153(29).

[917] In some cases vertical features may be provided using hardware and software external to the actual switch. In those instances, the functionality of such external hardware and software is a separate element under section 251(c)(3), and is available to competing providers. *See infra* Section V.I.4, discussing unbundled signaling and databases.

[918] *Illinois Wholesale Order* at 63-66.

[919] *See supra* Section V.H, rejecting arguments that services available for resale under section 251(c)(4) cannot be provided via unbundled elements.

[920] *See infra* Section VII.C.2.b.2, concerning the pricing of an unbundled switching element.

[921] AT&T June 28 *Ex Parte* at 1-2; MCI comments at 31; LDDS comments at 44.

should be activated by the incumbent LEC for that line. In addition, the record indicates that the incremental costs associated with vertical switching features on a per-line basis may be quite small,[922] and may not justify the administrative difficulty for the incumbent LEC or the arbitrator to determine a price for each vertical element. Thus, states can investigate, in arbitration or other proceedings, whether vertical switching features should be made available as separate network elements. We will continue to review and revise our rules in this area as necessary.

415. We conclude that providing access to an unbundled local switching element at a LEC central office is technically feasible. We are not persuaded by the argument that shared use of an unbundled switching element would jeopardize network security and reliability by permitting competitors independently to activate and deactivate various switching features. A competing provider will purchase and obtain the local switching element the same way it obtains an unbundled local loop, that is, by ordering, via electronic interfaces,[923] the local switching element and particular vertical switching features.[924] The incumbent LEC will receive the order and activate (or deactivate) the particular features on the customer line designated by the competing provider. Consequently, the incumbent LEC is not required to relinquish control over operations of the switch.

416. We also reject the argument that a definition of local switching that incorporates shared use of a local switch would involve physical partitioning of the switch.[925] The requirements we establish for local switch unbundling do not entail physical division of the switch, and consequently do not impose the inefficiency or technical difficulties identified by some commenters.

417. Nor are we persuaded by the arguments of some incumbent LECs that an unbundled switching element based on shared use of the local switch is technically infeasible because incumbent LECs lack significant excess capacity at any given time. Initially, many requests for local switching elements from competitors will likely result from the loss of customers by the incumbent LEC. Thus, at least initially, an increase in the use of a local switch by the requesting carrier is not likely to lead to an enormous, immediate increase in switch use overall. If incumbent LECs and competing providers believe that they would

[922] LDDS comments at 57, Letter from Bruce Cox, Government Affairs Director, AT&T, to Elliot Maxwell, FCC, June 25, 1996 (AT&T June 25 *Ex Parte*).

[923] *See infra* Section V.I.4, *infra*, addressing requesting carriers' access to incumbent LECs' ordering and provisioning systems.

[924] Section V.I.5 addresses the arrangements for ordering unbundled network elements.

[925] U S West comments at 55-57.

benefit by quantifying their anticipated demand for switch resources, they are free to do so in the negotiation and arbitration processes. Such planning may be necessary when a competitor anticipates that usage of the local switching element by its customers will place demands on the incumbent LEC's switch that exceed the usage levels anticipated by the incumbent LEC.[926]

418. We conclude that customized routing, which permits requesting carriers to designate the particular outgoing trunks that will carry certain classes of traffic originating from the competing provider's customers, is technically feasible in many LEC switches. Customized routing will enable a competitor to direct particular classes of calls to particular outgoing trunks, which will permit a new entrant to self-provide, or select among other providers of, interoffice facilities, operator services, and directory assistance.[927] Bell Atlantic notes that customized routing is generally technically feasible for local calling, although it notes that the technology and capacity constraints vary from switch to switch.[928] SBC contends that customized routing is technically infeasible for older switches, such as the 1AESS switch.[929] AT&T acknowledges that, although the ability to establish customized routing in 1AESS switches may be affected by the "call load" in each office, only 9.8% of the switches used by the seven RBOCs, GTE and SNET are 1AESS switches.[930] We recognize that the ability of an incumbent LEC to provide customized routing to a requesting carrier will depend on the capability of the particular switch in question. Thus, our requirement that incumbent LECs provide customized routing as part of the "functionality" of the local switching element applies, by definition, only to those switches that are capable of performing customized routing. An incumbent LEC must prove to the state commission that customized routing in a particular switch is not technically feasible.

[926] Bell Atlantic, for example, notes that a competitor's service or pricing packages could stimulate greater switch usage than previously experienced by the incumbent. Letter from Patricia Koch, Assistant Vice President, Bell Atlantic, to William Caton, Acting Secretary, FCC, June 21, 1996 (Bell Atlantic June 21 *Ex Parte*).

[927] *See, e.g.*, AT&T June 28 *Ex Parte*. In addition, we note that the Illinois Commission recently directed Ameritech and Centel to permit a carrier purchasing wholesale local exchange service to designate a provider of operator services and directory assistance other than that of the incumbent LEC. Such access is accomplished through the routing of such calls from the incumbent LEC's switch to the competing provider of the operator service or directory assistance. *See Illinois Wholesale Order* at 45.

[928] Letter from Patricia Koch, Assistant Vice President, Bell Atlantic, to William Caton, Acting Secretary, FCC, June 24, 1996 (Bell Atlantic June 24 *Ex Parte*); *see also* BellSouth comments at 41-42 n.89 (the ability to provide customized routing depends on the quantity of customized routing requests from other competitors).

[929] SBC comments at 41-42.

[930] Letter from Bruce Cox, Government Affairs Director, AT&T, to William F. Caton, Secretary, FCC, July 11, 1996 (AT&T July 11 *Ex Parte*).

419. Section 251(d)(2)(A) requires the Commission, in determining which network elements should be made available to competing providers, to consider "whether access to such network elements as are proprietary in nature is necessary."[931] To withhold a proposed network element from a competing provider, an incumbent LEC must demonstrate that the element is proprietary and that gaining access to that element is not necessary because the competing provider can use other, nonproprietary elements in the incumbent LEC's network to provide service.[932] U S West asserts that switch unbundling could raise concerns involving, among other things, "licensing of intellectual property." It cites a request by one interconnector to be the exclusive provider of particular features in U S West's generic switching software.[933] Bell Atlantic states that it is not at liberty to sub-license the software that operates vertical switching features.[934] We note, however, that these incumbent LECs do not object to providing vertical switching functionalities to requesting carriers under the resale provision of section 251(c)(4).[935] In addition, the vast majority of parties that discuss unbundled local switching do not raise proprietary concerns with the unbundling of either basic local switching or vertical switching features. Even if we accept the claim of U S West and Bell Atlantic that vertical features are proprietary in nature, these carriers do not meet the second consideration in our section 251(d)(2)(A) standard, which requires an incumbent LEC to show that a new entrant could offer the proposed telecommunications service through the use of other, nonproprietary elements in the incumbent LEC's network.[936] Accordingly, we find that access to unbundled local switching is clearly "necessary" under our interpretation of section 251(d)(2)(A).[937]

420. Section 251(d)(2)(B) directs the Commission to consider whether the failure to provide access to an unbundled element "would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[938] We have interpreted

[931] 47 U.S.C. § 251(d)(2)(A).

[932] *See supra* Section V.E.

[933] U S West comments at 55 n.117.

[934] Bell Atlantic comments, Albers Attachment at 17-18.

[935] U S West reply at 26-27; Bell Atlantic comments at 26.

[936] *See supra* Section V.E.

[937] *Id.*

[938] 47 U.S.C. § 251(d)(2)(B).

the term "impair" to mean either increased cost or decreased service quality that would result from using network elements of the incumbent LEC other than the one sought.[939] SBC and MFS contend that access to unbundled local switching may not be essential for new entrants because competitors are likely to deploy their own switches.[940] These parties present no evidence that competitors could provide service using another element in the LEC's network at the same cost and at the same level of quality. In addition, most commenters that address this issue generally argue that local switching is essential for the provision of competing local service,[941] and we agree. We thus conclude that a requesting carrier's ability to offer local exchange services would be impaired, if not thwarted, without access to an unbundled local switching element.

421. Section 251(c)(3) requires that incumbent LECs provide access to unbundled network elements on terms and conditions that are "just, reasonable, and nondiscriminatory."[942] We agree with CompTel and LDDS that new entrants will be disadvantaged if customer switchover is not rapid and transparent. We also note that the Michigan Commission has recognized the significance of customer switchover intervals and has directed Ameritech and GTE to file proposals on how they will "ensure the equal availability of expeditious processing of local, interLATA, and intraLATA carrier changes."[943] Therefore, we require incumbent LECs to switch over customers for local service in the same interval as LECs currently switch end users between interexchange carriers. This requirement applies to switchovers that only require the incumbent LEC to make changes to software. Switchovers that require the incumbent LEC to make physical modifications to its network, such as connecting a competitor's loop to its switch, are not subject to this requirement, and instead are governed by our terms and conditions for all unbundled elements.[944] Today, incumbent LECs routinely change customers' presubscribed interexchange carriers quickly and transparently, thereby contributing to the competitiveness of the interexchange market. We

---

[939] *See supra* Section V.E.

[940] SBC reply at 23; MFS comments at 46.

[941] *See, e.g.*, LDDS reply at 18 (unbundled local switching is "critical" to local competition); TIA comments at 18; AT&T Mar. 21 Letter at 17-18.

[942] 47 U.S.C. § 251(c)(3).

[943] *In the Matter, On the Commission's Own Motion, To Establish Permanent Interconnection Arrangements Between Basic Local Exchange Service Providers*, Opinion and Order, Mich. Pub. Serv. Comm'n, Case No. U-10860, at 36-37 (June 5, 1996).

[944] *See supra* Section V.G., discussing provisioning intervals for unbundled network elements.

expect that a similar requirement for local exchange switchovers that require only a software change will similarly contribute to local exchange competition.

422. We reject the proposal by some incumbent LECs to define unbundled local switching as the facilities that provide a *point of access* to the switch, but that would not actually include switching functionality. Under this definition, the purchaser of the local switching element would not actually obtain local switching, only the right to purchase local switching functionality and other switching features at wholesale rates. We believe that the unbundled local switching element must include the functionality of connecting lines and trunks. The definition proposed by these incumbent LECs would contravene the requirement in section 251(c)(3) that incumbent LECs provide network elements "in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service."[945] If a competing provider combined its own loops and transport with the local switching element ("point of access"), it would be unable to provide telecommunications service without separately purchasing, at wholesale rates, switching functionality from the incumbent LEC.

423. We also disagree with the proposal to define local switching as a point of access plus basic switching functionality, but that would exclude vertical switching features.[946] As a legal matter, this definition is inconsistent with the 1996 Act's definition of "network element," which includes all the "features, functionalities, and capabilities provided by means of such facility or equipment."[947] In addition, this definition would not fulfill the pro-competitive objectives of the 1996 Act as effectively as the per-line definition we adopt. A competitor that obtains basic and vertical switching features at cost-based rates will have maximum flexibility to distinguish its offerings from those of the incumbent LEC by developing a variety of service packages and pricing plans.[948] Moreover, an upfront purchase of all local switching features may speed entry by simplifying practical issues such as the pricing of individual switching features.

424. We also address the impact on small incumbent LECs. For example, the Illinois Independent Telephone Association and the Rural Telephone Coalition favor rules that

---

[945] 47 U.S.C. § 251(c)(3).

[946] Sprint comments at 34; USTA reply at 16-17; SBC reply at 20; NYNEX reply at 31; MECA comments at 29.

[947] 47 U.S.C. § 153(29); *see supra* section V.C., which interprets the Act's definition of "network element."

[948] *See, e.g.*, LDDS comments at 33; AT&T comments at 21.

recognize the differences between larger and smaller LECs.[949] We have considered the economic impact of our rules in this section on small incumbent LECs. In this section, for example, we expressly provide for the fact that certain LECs may possess switches that are incapable of performing customized routing for competitors that purchase unbundled local switching. As noted by Rural Telephone Coalition and the Illinois Independent Telephone Coalition, this approach is necessary to accommodate the different technical capabilities of large and small carriers. We also note that section 251(f) of the 1996 Act provides relief for certain small LECs from our regulations under section 251.

(2) Tandem Switching Capability

425. We also affirm our tentative conclusion in the NPRM that it is technically feasible for incumbent LECs to provide access to their tandem switches unbundled from interoffice transmission facilities. We note that some states already have required incumbent LECs to unbundle tandem switching.[950] Parties do not contend, pursuant to section 251(d)(2)(A), that tandem switches are proprietary in nature. With regard to section 251(d)(2)(B), we find that competitors' ability to provide telecommunications service would be impaired without unbundled access to tandem switching. Therefore, we find that the availability of unbundled tandem switching will ensure that competitors can deploy their own interoffice facilities and connect them to incumbent LECs' tandem switches where it is efficient to do so.

426. We define the tandem switch element as including the facilities connecting the trunk distribution frames to the switch, and all the functions of the switch itself, including those facilities that establish a temporary transmission path between two other switches. The definition of the tandem switching element also includes the functions that are centralized in tandems rather than in separate end office switches, such as call recording, the routing of calls to operator services, and signaling conversion functions.

(3) Packet Switching Capability

427. At this time, we decline to find, as requested by AT&T and MCI, that incumbent LECs' packet switches should be identified as network elements. Because so few parties commented on the packet switches in connection with section 251(c)(3), the record is insufficient for us to decide whether packet switches should be defined as a separate network element. We will continue to review and revise our rules, but at present, we do not adopt a national rule for the unbundling of packet switches.

---

[949] Illinois Ind. Tel. Ass'n comments at 1; Rural Tel. Coalition reply at 37.

[950] *See, e.g.*, Ameritech comments at 43, Cincinnati Bell comments at 18, GTE comments at 38, AT&T March 21 Letter at 23.

3. Interoffice Transmission Facilities

a. Background

428. In the NPRM, we proposed to require incumbent LECs to make available unbundled transport facilities in a manner that corresponds to the rate structure for interstate transport charges. We specifically proposed to require unbundled access to links between the end office and the serving wire center (SWC), the SWC and the IXC point of presence (POP), the end office and the tandem switch, and the tandem switch and the SWC. We also tentatively concluded that incumbent LECs should be required to unbundle channel termination facilities for special access from the interoffice facilities. In addition, we requested comment on whether and how other interoffice facilities used by incumbent LECs should be unbundled.

b. Comments

429. The vast majority of the parties that discussed local transport unbundling supported the Commission's proposal to provide access to dedicated and shared interoffice facilities as unbundled network elements.[951] BellSouth, for example, asserts that individual transport components should be available as unbundled elements, and notes that some LECs already have unbundled transport from its other access services.[952]

430. Several incumbent LECs contend that they already provide unbundled transport services pursuant to the Commission's *Expanded Interconnection* rules.[953] PacTel asserts that its proposal to tariff unbundled transport elements, including dedicated transport and tandem-switched transport, will fulfill its duties under sections 251 and 271.[954] Bell Atlantic and TIA, on the other hand, indicate that existing tariffs for unbundled transport facilities are

---

[951] AT&T comments at 22; USTA comments at 35; Frontier comments at 16; GCI comments at 12; Sprint comments at 39; GST comments at 24; NYNEX comments at 63; NEXTLINK comments at 23; ACSI comments at 41; MCI comments at 17; ALTS comments at 30; Citizens Utilities comments at 15; CompTel comments at 45; TIA comments at 13; Bell Atlantic comments at 22; U S West comments at 48; Teleport comments at 37; MFS comments at 48; USTA comments at 35; TCC comments at 35; New York Commission comments at 27; Ameritech comments at 43; BellSouth comments at 42.

[952] BellSouth comments at 42-43.

[953] Ameritech comments at 42-43; Cincinnati Bell comments at 18; GTE comments at 38.

[954] PacTel comments at 57.

insufficient to comply with the 1996 Act.[955] MFS asks the Commission to clarify that, under the expanded interconnection rules as well as the 1996 Act, incumbent LECs must unbundle all interoffice transport facilities without requiring the requesting carrier to purchase channel terminations or other elements.[956]

431. Parties agree that local transport unbundling is technically feasible.[957] MCI, for example, asserts that transport facilities are already unbundled for exchange access and thus there is no question that unbundling is technically feasible.[958] NCTA, GST, TIA, and MFS contend that unbundling transport elements should be presumed technically feasible because of the Commission's *Expanded Interconnection* proceeding.[959] AT&T and Telecommunications Resellers Association point out that IXCs currently obtain interconnections between transport elements and the tandem switches pursuant to standard specifications.[960]

432. A number of commenters specify particular components of local transport that should be unbundled: (1) dedicated transport trunks from incumbent LEC end offices to competitors' switches, to IXC POPs, and to other end offices of the incumbent LEC; and (2) common transport trunks between incumbent LEC end offices and tandem switches.[961] In addition, ALTS, MFS, AT&T, and MCI contend that requesting carriers should have the ability to order such transport trunks with or without electronics (*i.e.*, as "dark fiber").[962] GTE disagrees and argues that the definition of network element only encompasses facilities "*used*

[955] Bell Atlantic comments at 27 (Bell Atlantic has already filed, or plans to file, intrastate tariffs for the network elements it has unbundled under expanded interconnection.); TIA comments at 13.

[956] MFS comments at 48; *accord* AT&T comments at 22; MCI comments at 17.

[957] *See, e.g.*, GST comments at 24; AT&T comments at 22; GTE reply at 18-19; GVNW comments at 28; NYNEX comments at 65; MCI comments at 32; Comcast comments at 18; CompTel comments at 31; NCTA comments at 42; MFS comments at 48; Telecommunications Resellers Ass'n comments at 35; Ameritech comments at 43.

[958] MCI comments at 32.

[959] NCTA comments at 42; GST comments at 24; TIA comments at 13; MFS comments at 47-48.

[960] AT&T comments at 22; Telecommunications Resellers Ass'n comments at 35.

[961] *See, e.g.*, AT&T comments at 22; NYNEX comments at 62-63; GVNW comments at 20; TCC reply at 18; ACSI comments, Attachment 1 at 5-6.

[962] ALTS comments at 30; MCI comments at 32; AT&T comments at 22; MFS comments at 48.

in the provision of telecommunications service," and that dark fiber does not meet this definition because LECs do not "use" it in their networks.[963]

433. Several parties ask that the Commission specify additional transport components as unbundled network elements beyond those proposed in the NPRM. AT&T contends that incumbent LECs should have to unbundle their digital cross-connect systems (DCSs), which are now used to disaggregate high-speed traffic from IXCs into individual circuits.[964] MCI and AT&T contend that these facilities will enable IXCs to use more cost-efficient, high-speed facilities to route traffic to the incumbent LEC and have the traffic disaggregated into individual circuits at the DCS.[965] CompTel asserts that, when direct-trunked transport transits a tandem switch or other intermediate node, incumbent LECs should offer each individual link as an unbundled element.[966] MCI also asserts that competitors need "loop transport" to carry traffic from the incumbent's unbundled loops to the competitor's switch.[967]

434. A number of parties assert that the availability of unbundled transport facilities would promote local competition. AT&T contends that it seeks to combine unbundled common transport with competitive tandem switching and dedicated transport to provide IXCs with alternative access service from the competitor's end office to the IXC POP.[968] AT&T, Telecommunications Resellers Association, and TIA assert that the availability of unbundled dedicated transport will allow competitors to connect their switches to incumbent LEC switches efficiently.[969] MCI contends that incumbent LECs have denied MCI access to trunks between the incumbent LECs' end offices, thereby increasing MCI's costs of deploying local facilities and restricting MCI's ability to acquire redundant facilities for its local traffic.[970] NYNEX and LDDS recommend that the Commission require incumbent LECs to offer unbundled dedicated transport between their own end office or tandem switches and the

[963] GTE reply at 21.

[964] AT&T comments at 22 n.23; *accord* SBC comments at 87.

[965] AT&T comments at 22; MCI comments at 17.

[966] CompTel comments at 45.

[967] MCI comments at 22.

[968] AT&T Mar. 21 Letter at 22.

[969] *Id.*; Telecommunications Resellers Ass'n comments at 35; TIA comments at 13.

[970] MCI comments at 46.

requesting carrier's switch or POP.[971] The Texas Public Utility Commission has specifically required incumbent LECs to provide competitors with "loop facilities transport service," which connects an unbundled loop to the competitor's switch.[972]

435. Several parties caution that pricing distortions could accompany a ruling that transport components are network elements under section 251(c)(3).[973] GTE, for example, argues that the Commission should not permit requesting carriers to use unbundled transport elements to avoid access charges.[974] Similarly, Ameritech states that the 1996 Act prohibits arbitrary price distinctions between switched and special transport, and that, if interoffice facilities are unbundled from tandem switching, no such distinction can be made.[975] Other parties maintain that the 1996 Act requires cost-based pricing of all unbundled elements, including transport elements.[976]

436. A few parties oppose a requirement that incumbent LECs unbundle facilities that correspond to interstate transport and special access rate elements.[977] Cincinnati Bell argues that these elements are already available through existing tariffs, and therefore should not be required to be offered as unbundled elements pursuant to the 1996 Act.[978] MECA argues that local transport and special access facilities are toll access facilities and therefore are not necessary to provide competitive basic local exchange service.[979] MECA also states that any requirement concerning local transport and special access should not apply to any LEC that was not covered by the MFJ restrictions and, in order to minimize arbitrage opportunities, any

[971] NYNEX comments at 63 n.126; LDDS reply at 18.

[972] Texas Commission comments at 18.

[973] *See e.g.*, GTE comments at 38; CompTel comments at 45; Ameritech comments at 43.

[974] GTE comments at 38.

[975] Ameritech comments at 43.

[976] ACSI comments at 42; MCI comments at 32.

[977] *See, e.g.*, MECA comments at 38; Cincinnati Bell comments at 18.

[978] Cincinnati Bell comments at 18.

[979] MECA comments at 38.

modifications to local transport and special access must wait until the LECs have restructured their local rates.[980]

437. TCC urges the Commission to define dedicated transport as an interoffice transmission path dedicated to a single carrier, including multiplexing and grooming, redundant facilities, and cross-office wiring to a digital cross-connect panel.[981] ACSI argues that the Commission should require incumbent LECs to make both dedicated and switched transport available at the DS-0, DS-1, DS-3 and Optical Carrier levels, which should be offered as completely unbundled links between serving wire centers (SWCs) and interconnector points-of-presence, the central office and the SWC, the end office and the tandem, and the SWC and the tandem.[982] Teleport advocates that interoffice trunking facilities be defined in terms of their underlying transmission characteristics without reference to the use of the facility.[983]

438. ALTS argues that, since there are currently well-defined standards for transport, there should be no impediment to requiring equivalent levels of technical performance among competing carriers, *i.e.*, no meaningful distinctions among the technical performance of different DS1s.[984] Therefore, as in the case with local loops, ALTS contends that competitors should receive the same or better ordering, provisioning, and installation service as the incumbent provides itself and that penalties should be assessed if deadlines are not met.[985]

c. Discussion

439. We conclude that incumbent LECs must provide interoffice transmission facilities on an unbundled basis to requesting carriers. The record supports our conclusion that such access is technically feasible and would promote competition in the local exchange

[980] MECA comments at 38.

[981] TCC comments at 38; *see also* NYNEX comments at 63 for a similar definition.

[982] ACSI comments at 41.

[983] Teleport comments at 37.

[984] ALTS comments at 30.

[985] *Id.* at 30-31.

market. We note that the 1996 Act requires BOCs to unbundle transport facilities prior to entering the in-region, interLATA market.[986]

440. We require incumbent LECs to provide unbundled access to shared transmission facilities between end offices and the tandem switch.[987] Further, incumbent LECs must provide unbundled access to dedicated transmission facilities between LEC central offices or between such offices and those of competing carriers. This includes, at a minimum, interoffice facilities between end offices and serving wire centers (SWCs), SWCs and IXC POPs, tandem switches and SWCs, end offices or tandems of the incumbent LEC, and the wire centers of incumbent LECs and requesting carriers. The incumbent LEC must also provide, to the extent discussed below, all technically feasible transmission capabilities, such as DS1, DS3, and Optical Carrier levels (*e.g.* OC-3/12/48/96) that the competing provider could use to provide telecommunications services. We conclude that an incumbent LEC may not limit the facilities to which such interoffice facilities are connected, provided such interconnection is technically feasible, or the use of such facilities. In general, this means th incumbent LECs must provide interoffice facilities between wire centers owned by incumben LECs or requesting carriers, or between switches owned by incumbent LECs or requesting carriers. For example, an interoffice facility could be used by a competitor to connect to the incumbent LEC's switch or to the competitor's collocated equipment. We agree with the Texas Commission that a competitor should have the ability to use interoffice transmission facilities to connect loops directly to its switch. We anticipate that these requirements will reduce entry barriers into the local exchange market by enabling new entrants to establish efficient local networks by combining their own interoffice facilities with those of the incumbent LEC.

441. The ability of new entrants to purchase the interoffice facilities we have identified will increase the speed with which competitors enter the market. By unbundling various dedicated and shared interoffice facilities, a new entrant can purchase all interoffice facilities on an unbundled basis as part of a competing local network, or it can combine its own interoffice facilities with those of the incumbent LEC. The opportunity to purchase unbundled interoffice facilities will decrease the cost of entry compared to the much higher cost that would be incurred by an entrant that had to construct all of its own facilities. An efficient new entrant might not be able to compete if it were required to build interoffice facilities where it would be more efficient to use the incumbent LEC's facilities. We recognize that there are alternative suppliers of interoffice facilities in certain areas. We are convinced, however, that entry will be facilitated if competitors have greater, not fewer, options for procuring interoffice facilities as part of their local networks, and that Congress

[986] 47 U.S.C. § 271(c)(2)(B)(v).

[987] Section V.I. addresses unbundled access to the tandem switching element.

intended for competitors to have these options available from competitors. Thus, the rules we establish for the unbundled interoffice facilities should maximize a competitor's flexibility to use new technologies in combination with existing LEC facilities.

442. We find that it is technically feasible for incumbent LECs to unbundle the foregoing interoffice facilities as individual network elements. The interconnection and unbundling arrangements among the larger LECs, IXCs, and CAPs that resulted from our *Expanded Interconnection* rules confirm the technical feasibility of unbundling interoffice facilities used by incumbent LECs to provide special access and switched transport.[988] As AT&T and Telecommunications Resellers Association point out, IXCs currently interconnect with incumbent LECs' transport facilities pursuant to standard specifications.[989] We also note that commenters do not identify technical feasibility problems with unbundling interoffice facilities.

443. We also find that it is technically feasible for incumbent LECs to unbundle certain interoffice facilities not addressed in our *Expanded Interconnection* proceeding. First, we conclude that an incumbent LEC must provide unbundled access to interoffice facilities between its end offices, and between any of its switching offices and a new entrant's switching office, where such interoffice facilities exist. This allows a new entrant to purchase unbundled facilities between two end offices of the incumbent LEC, or between the new entrant's switching office and the incumbent LEC's switching office. Although our *Expanded Interconnection* rules did not specifically require incumbent LECs to unbundle these facilities, commenters do not identify any potential technical problem with such unbundling. Moreover, some LECs already offer unbundled dedicated interoffice facilities, for example, between their end offices and SWCs for exchange access.

444. In addition, as a condition of offering unbundled interoffice facilities, we require incumbent LECs to provide requesting carriers with access to digital cross-connect system (DCS) functionality. A DCS aggregates and disaggregates high-speed traffic carried between IXCs' POPs and incumbent LECs' switching offices, thereby facilitating the use of cost-efficient, high-speed interoffice facilities. AT&T notes that the BOCs, GTE, and other large LECs currently make DCS capabilities available for the termination of interexchange traffic.[990] We find that the use of DCS functionality could facilitate competitors' deployment of high-speed interoffice facilities between their own networks and LECs' switching offices.

[988] *See, e.g.*, MCI comments at 32; NCTA comments at 42; GST comments at 24; TIA comments at 13; MFS comments at 47-48.

[989] AT&T comments at 22; Telecommunications Resellers Ass'n comments at 35.

[990] Letter from Bruce Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, July 18, 1996.

Therefore, we require incumbent LECs to offer DCS capabilities in the same manner that they offer such capabilities to IXCs that purchase transport services.

445. We disagree with PacTel's assertion that it is not technically feasible for incumbent LECs to provide DCS functionality to competitors that purchase unbundled interoffice facilities.[991] First, contrary to PacTel's assertion, we do not require incumbent LECs to develop new arrangements for the offering of DCS capabilities to competitors. We only require that DCS capabilities be made available to competitors to the extent incumbent LECs offer such capabilities to IXCs. Second, PacTel suggests the provision of DCS capabilities requires physical partitioning of the DCS equipment in order to prevent carriers from gaining control of each other's traffic.[992] We do not require such partitioning for the provision of DCS capabilities. As noted above, we only require incumbent LECs to permit competitors to use DCS functionality in the same manner that incumbent LECs now permit IXCs to use such functionality.

446. Section 251(d)(2)(A) requires the Commission to consider whether "access to such network elements as are proprietary in nature is necessary."[993] Commenters do not identify any proprietary concerns relating to the provision of interoffice facilities that LECs are required to unbundle. We also note that many of these facilities are also currently offered on an unbundled basis to competing carriers. Therefore, the record provides no basis for withholding these facilities from competitors based on proprietary considerations.

447. Section 251(d)(2)(B) requires the Commission to consider whether the failure to provide access to an unbundled element "would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[994] We have interpreted the term "impair" to mean either increased cost or decreased service quality that would result from using network elements other than the one sought.[995] Certain commenters contend that unbundled access to these facilities would improve their ability to provide competitive local

[991] Letter from Alan Ciamporcero, Vice President, PacTel, to William F. Caton, Acting Secretary, FCC, July 17, 1996 (PacTel July 17 *Ex Parte*).

[992] *Id.*

[993] 47 U.S.C. § 251(d)(2)(A).

[994] 47 U.S.C. § 251(d)(2)(B).

[995] *See supra* Section V.E.

change and exchange access service.[996] MCI, for example, argues that its inability to obtain ibundled access to trunks between an incumbent LEC's end offices raises its cost of oviding local service.[997] Accordingly, we conclude that the section 251(d)(2)(B) requires cumbent LECs to provide access to shared interoffice facilities and dedicated interoffice cilities between the above-identified points in incumbent LECs' networks, including cilities between incumbent LECs' end offices, new entrant's switching offices and LEC itching offices, and DCSs. We believe that access to these interoffice facilities will iprove competitors' ability to design efficient network architecture, and in particular, to mbine their own switching functionality with the incumbent LEC's unbundled loops.[998]

448. We reject Cincinnati Bell's argument that existing tariffs for transport and ecial access services filed pursuant to our *Expanded Interconnection* rules fulfill our ligation to implement the requirements of section 251(c).[999] First, the *Expanded terconnection* rules require the unbundling of interstate transport services only by Class A rriers [1000] whereas section 251(c) requires network unbundling by all incumbent LECs, cept for carriers that are exempt under section 251(f) from our interconnection rules.[1001] nsequently, some non-Class A carriers that were not subject to our *Expanded terconnection* requirements will be required to comply with the requirements of this Order. cond, we find that the Class A carriers' existing tariffs for unbundled transport elements do t satisfy the unbundling requirement of section 251(c), as suggested by Cincinnati Bell, cause such tariffs are only for interstate access services, not for unbundled interoffice ilities. As such, existing federal tariffs for transport and special access exclude *intra*state nsport, and therefore are not equivalent to unbundled interoffice facilities, which we have termined to be nonjurisdictional in nature.

See, e.g., AT&T Mar. 21 Letter; LDDS Comments at 47.

MCI comments at 46.

See, e.g., MCI comments at 22.

Cincinnati Bell comments at 18.

Class A carriers are those exchange carriers having more than $100 million in total company regulated enues. *See 1990 Cost Support Order*, 5 FCC Rcd 1364, (Com. Car. Bur. 1990); *Commission Requirements Cost Support Material to be Filed with 1989 Annual Access Tariffs*, 4 FCC Rcd 1662, 1663 (Com. Car. Bur. 8).

See infra Section XII, addressing the exemption for rural LECs.

449. We also disagree with MECA, GTE, and Ameritech that we should consider "pricing distortions" in adopting rules for unbundled interoffice facilities.[1002] Section , below, addresses the pricing of unbundled network elements identified pursuant to section 251(c)(3) as it relates to our current access charge rules. Nor are we are persuaded by MECA's argument that incumbent LECs not subject to the MFJ should not be required to unbundle transport facilities because, according to MECA, such facilities are unnecessary for local competition.[1003] As discussed above, the ability of a new entrant to obtain unbundled access to incumbent LECs' interoffice facilities, including those facilities that carry interLATA traffic, is essential to that competitor's ability to provide competing telephone service.

450. We do not impose specific terms and conditions for the provision of unbundled interoffice facilities. We believe that the rules we establish in this Order for all unbundled network elements adequately address ALTS's concern regarding the provisioning, billing, and maintenance of unbundled transport facilities.[1004] We also decline at this time to address the unbundling of incumbent LECs' "dark fiber." Parties that address this issue do not provide us with information on whether dark fiber qualifies as a network element under sections 251(c)(3) and 251(d)(2). Therefore, we lack a sufficient record on which to decide this issue. We will continue to review and revise our rules in this area as necessary.

451. Rural Telephone Coalition contends that incumbent LECs should not be required to construct new facilities to accommodate new entrants.[1005] We have considered the economic impact of our rules in this section on small incumbent LECs. In this section, for example, we expressly limit the provision of unbundled interoffice facilities to *existing* incumbent LEC facilities. We also note that section 251(f) of the 1996 Act provides relief for certain small LECs from our regulations under section 251.

4. Databases and Signaling Systems

a. Background

(1) NPRM

[1002] MECA comments at 38, GTE comments at 38; Ameritech comments at 43.

[1003] MECA comments at 38.

[1004] Section V.G addresses terms and conditions governing incumbent LECs' provision of access to unbundled network elements.

[1005] Rural Tel. Coalition reply at 36.

452. In the NPRM, we tentatively concluded that incumbent LECs should be required to unbundle access to their signaling systems and databases as network elements.[1006] We asked commenters to identify points at which carriers interconnect with SS7 networks[1007] today, as well as the technical feasibility of establishing other points of access and interconnection.[1008] We also asked commenters to identify those signaling and database functions currently provided by incumbent LECs on an unbundled basis, and other functions not currently offered by incumbent LECs, that the parties believe should be offered on an unbundled basis.[1009]

453. In the NPRM, we noted the possibility that competitors that provide local exchange service using resold incumbent LEC services or unbundled elements might want to connect an alternative call processing database to the incumbent LEC's SS7 network in order to offer services and features not available through the incumbent LEC's own SS7 network databases.[1010]

454. We also sought comment on unbundling access to the Advanced Intelligent Network (AIN), and referenced our separate Intelligent Networks proceeding which deals with related issues.[1011] We sought comment on whether to unbundle access to AIN facilities and functionalities.

(2) SS7 Signaling Network Technology

455. Signaling systems facilitate the routing of telephone calls between switches. Most LECs employ signaling networks that are physically separate from their voice networks, and these "out-of-band" signaling networks simultaneously carry signaling messages for

[1006] NPRM at para. 107.

[1007] A signaling network that is physically separate from the voice networks.

[1008] NPRM at para. 108.

[1009] NPRM at para. 108.

[1010] NPRM at para. 112.

[1011] NPRM at para. 113; *see In the Matter of Intelligent Networks*, CC Docket No. 91-346, Notice of Inquiry, 6 FCC Rcd 7256 (1991), Notice of Proposed Rulemaking, 8 FCC Rcd 6813 (1993) (*Intelligent Networks*). We incorporated the record of the *Intelligent Network* proceeding into this docket by reference. NPRM at para. 113 n.151.

multiple calls. In general, most LECs' signaling networks adhere to a Bellcore standard Signaling System 7 (SS7) protocol.[1012]

456. SS7 networks use signaling links to transmit routing messages between switches, and between switches and call-related databases. A typical SS7 network includes a signaling link, which transmits signaling information in packets, from a local switch to a signaling transfer point (STP), which is a high-capacity packet switch.[1013] The STP switches packets onto other links according to the address information contained in the packet.[1014] These additional links extend to other switches, databases, and STPs in the LEC's network.[1015] A switch routing a call to another switch will initiate a series of signaling messages via signaling links through an STP to establish a call path on the voice network between the switches.

457. As mentioned above, the SS7 network also employs signaling links (via STPs) between switches and call-related databases, such as the Line Information Database (LIDB), Toll Free Calling (*i.e.*, 800, 888 number) database, and AIN databases. These links enable a switch to send queries via the SS7 network to call-related databases, which return customer information or instructions for call routing to the switch.[1016]

458. From the perspective of a switch in a LEC network, the databases discussed above merely supply information or instructions. Updating or populating the information in such databases, however, takes place through a separate process involving different equipment. Carriers input information directly into a service management system (SMS), which in turn downloads such information into the individual databases.

459. The Advanced Intelligent Network (AIN) is a network architecture that uses distributed intelligence in centralized databases to control call processing and manage network

[1012] The SS7 protocol is widely used and has been adopted by Bellcore, the American National Standards Institute, and the International Telecommunication Union--Telecommunication Standardization Sector. *See* Bellcore, BOC Notes on the LEC Networks (1994).

[1013] STPs are usually deployed in pairs for redundancy purposes. *Id.*

[1014] Any element capable of handling SS7 signaling messages is also generally referred to as a Signaling Point. Each Signaling Point has a unique network address and every SS7 signaling message has a routing label containing addresses for the origination and destination of the message plus a signaling link selection code. *Id.*

[1015] For example, an STP to STP connection is generally used for inter-network interconnection. An STP to switch connection is a common part of the SS7 network and is used to connect end offices to the SS7 network. A connection between a call-related database and a switch is usually done via a connection at an STP (*i.e.*, database to STP to switch). *Id.*

[1016] Switch software commonly referred to as a "trigger" interrupts call progress, in order for the switch to query call-related databases. *Id.*

information, rather than performing those functions at every switch. An AIN-capable switch[1017] halts call progress when a resident software "trigger" is activated, and uses the SS7 network to access intelligent databases, known as Service Control Points (SCPs), that contain service software and subscriber information, for instruction on how to route, monitor, or terminate the call.[1018] AIN is being used in the deployment of number portability, wireless roaming, and such advanced services as same number service (i.e., 500 number service) and voice recognition dialing. AIN services are designed and tested in an off-line computer known as a Service Creation Environment (SCE). Once a service is successfully tested, the software is transferred to an SMS that administers and supports SCP databases in the network. The SMS then regularly downloads software and information to an SCP where interaction with the voice network takes place via the signaling links and STPs discussed above.

b. Comments

460. Almost all parties, including incumbent LECs, support the Commission's tentative conclusion to require incumbent LECs to unbundle access to their signaling systems.[1019] Parties generally agree that access to SS7 network signaling is essential to the provision of competitive local exchange service and that providing such access is technically feasible.[1020] Indeed, most BOCs state that they already provide access to their signaling

[1017] A switch with AIN capabilities is referred to as a service switching point (SSP). *Id.*

[1018] Switch queries and database responses use a part of the SS7 protocol called the Transaction Capabilities Application Part (TCAP). *Id.*

[1019] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 24; ACSI comments at 42; ALTS comments at 31; AT&T comments at 23; Comcast comments at 20; Ericsson comments at 5; GCI comments at 12; GST comments at 24; Intermedia comments at 13; MFS comments at 48-49; MCI comments at 32; Sprint comments at 39; Teleport comments at 37; Time Warner comments at 44-45; Ameritech comments at 46-47; BellSouth comments at 43; NYNEX comments at 71; PacTel comments at 57-60; Alabama Commission comments at 18; District of Columbia Commission comments at 23; Florida Commission comments at 17; Mass. Commission comments at 7; New York Commission comments at 27; Wyoming Commission comments at 23. These parties also generally support access to databases associated with signaling. Some parties, however, urge the Commission to weigh the potential harm from access to database and signaling systems, which might give someone the opportunity to cause inadvertent or malicious damage to large parts of the public switched network. Secretary of Defense comments at 6-7; Sprint comments at 39-40; Lincoln Tel. reply at 15; GVNW comments at 20, 29 (screening necessary to prevent network failures from proliferating between interconnected networks).

[1020] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 24; ACSI comments at 42; ALTS comments at 31; AT&T comments at 23; Citizens Utilities comments at 15; CompTel comments at 43; Continental comments at 19; Ericsson comments at 5; Frontier comments at 16; GCI comments at 12; LCI comments at 18; MCI comments at 32; NEXTLINK comments at 23; Sprint comments at 39-40; TIA comments at 14; Ameritech comments at 47; Bell Atlantic comments at 27-28; GTE comments at 38-41; U S West comments at 57-58; California Commission comments at 26; Colorado Commission comments at 24; Louisiana Commission comments at 5; Wyoming Commission comments at 23-24; USTN reply at 4.

systems.[1021] BellSouth states that it currently provides such access at its STPs via signaling links to all carriers, including IXCs, independent telephone companies, wireless carriers, and other local exchange carriers.[1022] Commenters also report that independent SS7 network aggregators currently provide access to signaling systems to many independent local exchange and interexchange carriers, and to some competitive local carriers.[1023] In addition, several state commissions note that they already have, or are considering, a requirement that incumbent LECs unbundle access to their signaling systems, including associated databases.[1024]

461. Some incumbent LECs argue that, because there are competitive providers for SS7 network services, there is no need for the Commission to require incumbent LECs to unbundle these network elements for competing carriers.[1025] Most potential competitors counter that access to incumbent LEC SS7 networks will be necessary for some carriers, either because alternative providers of signaling systems and databases will not be available to them or because it will not be technically feasible to use any signaling network other than the incumbent LEC's SS7 network.[1026] AT&T argues that, even where there are alternative SS7

[1021] Ameritech comments at 46-47; Bell Atlantic comments at 27-30; BellSouth comments at 43; GTE comments at 40-41; NYNEX comments at 71; PacTel comments at 58-59; SBC comments at 46-48; Sprint comments at 39-41; USTA comments at 36.

[1022] BellSouth comments at 43.

[1023] AT&T comments at 23; BellSouth comments at 44-45; NYNEX comments at 71; GVNW comments at 29 (most small incumbent LECs obtain SS7 functionalities from US Intelco or a neighboring large incumbent LEC); GTE comments at 40-41 n.61 (competitors include Independent Telecommunications Network, Southern New England Telephone, and GTE Intelligent Network Services); NYNEX comments at 71; PacTel comments at 58; Bell Atlantic comments at Attachment 3, 16 (independent SS7 providers offer an out-of-band signaling channel which allows the service providers to interconnect with other SS7 networks); USTN reply at 1. Commenters note that these aggregators also provide access to databases associated with signaling.

[1024] *See, e.g.*, California Commission comments at 26 (under consideration by the California Commission); Colorado Commission comments at 24; Louisiana Commission comments at Attachment A; Michigan Commission comments at 12; Texas Commission comments at 19; Wyoming Commission comments at 23-24 (Wyoming Commission has draft rules only); In the Matter of the Commission Investigation Relative to the Establishment of Local Exchange Competition and Other Competitive Issues, Case No. 95-845-TP-COI at 49 (Ohio Commission June 12, 1996) (access to SS7 functionalities, and necessary customer databases such as 911, LIDB, Toll Free Calling, and Directory Assistance).

[1025] *See, e.g.*, Bell Atlantic comments at 27-28; BellSouth comments at 44-45; GTE comments at 40-41 (access is not necessary under section 251(d)(2)(A) to the extent it is proprietary and denial of such access would not impair the provision of competitive services under section 251(d)(2)(B) to the extent it is not proprietary); PacTel comments at 40, 57-60; NYNEX comments at 71 (there are already alternative suppliers of these functions, and as demand grows, more will enter the market).

[1026] *See* AT&T comments at 23; Letter from Frank Simone, Regulatory Division Manager, Federal Government Affairs, AT&T to William Caton, Acting Secretary, FCC, June 13, 1996 (AT&T June 13 *Ex Parte*).

networks, unbundling of the incumbent's SS7 network will increase competition and help control costs for new entrants.[1027]

462. Some incumbent LECs contend that the 1996 Act only requires them to unbundle access to their signaling systems and databases to the extent necessary to support call routing and completion for competitors.[1028] Other parties, including IXCs, disagree and contend that access to incumbent LECs' signaling systems under the 1996 Act should include access to all associated databases and use of deployed AIN technology, and that such access is necessary in order for them to compete successfully in the local exchange market.[1029]

463. Many parties argue that open access and interconnection to incumbent LECs' SS7 networks and signaling protocols are critical to maintaining the seamless routing and completion of traffic between competing carriers.[1030] Frontier asserts that the use of proprietary or closed protocols by incumbent LECs effectively can prevent interconnected networks from communicating with each other.[1031] Several state commissions have proposed or required that incumbent LECs provide unaltered transmission of signaling information between interconnecting carriers and their customers.[1032] In support of such access, several commenters cite recent interconnection agreements that provide for the exchange of SS7 signaling messages.[1033]

[1027] AT&T comments at 23; *accord* Telecommunications Resellers Ass'n comments at 36.

[1028] ALLTEL comments at 10; Ameritech comments at 46-47; Bell Atlantic comments at 22.

[1029] *See, e.g.*, AT&T comments at 23; MCI reply at 30-31.

[1030] ACSI comments at 45 (open access is important to support CLASS features and access to databases); Frontier comments at 16; GST comments at 24; MCI comments at 33; New York Commission comments at 27 (signaling systems may represent a bottleneck to efficient exchange of traffic for all LECs); Texas Commission comments at 20; Wyoming Commission comments at 24; USTN reply comments at 2.

[1031] Frontier comments at 16 n.31 (such anti-competitive behavior would be contrary to the pro-competitive goals of the 1996 Act); *accord* Wyoming Commission comments at 24 (incumbent LECs may not claim a proprietary right to signaling protocols).

[1032] Wyoming Commission comments at 23-24 (Wyoming Commission draft rules require unaltered transmission of signaling information); Texas Commission comments at 19 (Texas law requires interconnecting carriers to provide nondiscriminatory access to ensure the interoperability of networks and service to end users).

[1033] Georgia Commission comments at Attachment E 6-7 (BellSouth and MCIMetro interconnection agreement provides for the exchange of SS7 signaling messages including the Transaction Capabilities Application Part (TCAP) part of the SS7 protocol that supports *inter alia* CLASS features).

464. Virtually all parties agree that physical access, or interconnection, to the incumbent LEC's SS7 network should occur at the STP, because it provides essential network management and security functions that are not performed by other SS7 network elements.[1034] Commenters assert that such access at the STP would provide other carriers with access to all of the functions of an incumbent LEC's SS7 network.[1035] A few parties urge the Commission to require incumbent LECs to unbundle direct access to SCP databases.[1036] Most commenters, including all of the incumbent LECs, assert that such access is not technically feasible because SCP databases do not perform the mediation functions present at the STP.[1037] Some incumbent LECs argue that direct access to any SS7 network elements, other than the STP, would require development of additional industry standards before such access could be considered technically feasible.[1038]

465. Several parties advocate access to unbundled signaling links and STPs.[1039] BellSouth, however, argues that incumbent LECs should only have to provide access to their SS7 network at an STP for competitors.[1040] Parties describe several methods for competing

[1034] *See, e.g.*, Ameritech comments at 48-50; Bell Atlantic comments at 27; MCI comments at 34-35; NYNEX comments at 71; Sprint comments at 40. Part of the STP security function is to screen incoming signaling traffic for unusable messages and to prevent them from reaching the SCP or switch where they could potentially cause reliability and performance problems. GVNW comments at 29; SBC comments at 46; USTA comments at 36. The STP also prevents unauthorized access to proprietary information. GTE comments at 39-40.

[1035] Bell Atlantic comments at 27; GTE comments at 39; USTA comments at 36. *See* AT&T comments at 24 n.25.

[1036] Frontier comments at 16; LCI comments at 18.

[1037] *See, e.g.*, ACSI at 45; Bell Atlantic comments at 27-28; Colorado Commission comments at 24 (Colorado Commission requires unbundled access to the SCP via the STP); Comcast comments at 18; GTE comments at 40 (until appropriate mediation techniques and associated software and hardware are developed, access to SCP databases should remain through the STP); PacTel comments at 59; NYNEX comments at 71; SBC comments at 47; Ameritech reply at 20-21 (industry has yet to develop standards for SCP access); AT&T reply at 19-20 n.32; PacTel reply at 21-22.

[1038] GTE comments at 40; SBC comments at 47; Sprint comments at 40.

[1039] ALTS comments at Attachment A, 23; AT&T comments at 23; Cable & Wireless comments at 19, 24-25; Citizens Utilities comments at 15; GCI comments at 12; Frontier comments at 16; Telecommunications Resellers Ass'n comments at 35; NYNEX comments at 71 (provides unbundled access to network signaling resources for call set up and for database queries through unbundled signaling links and ports at its STPs); PacTel reply at 21-22; TIA comments at 14; California Commission comments at 26 (California Commission is considering *inter alia*, unbundling STPs and signaling links); Colorado Commission comments at 26; Wyoming Commission comments at 23-24 (Wyoming Commission draft rules require unbundling of signaling links, STPs, and SCPs); Iowa Commission comments at Appendix B, 4 (arguing that signaling links and STPs must be unbundled by incumbent LECs).

[1040] BellSouth reply at 23.

carriers to access unbundled elements of the incumbent LEC's SS7 network. A new entrant could provide or purchase signaling links to connect its switch to the incumbent LEC's STP, or it could provide its own signaling link and STP and then connect its STP to the incumbent LEC's STP.[1041] SBC adds that a competing carrier could also contract with a third party that has already established signaling link connectivity to the incumbent LEC's STPs.[1042] SBC also notes that it requires certification of new companies before implementing SS7 interconnection in order to protect the integrity of its network.[1043]

466. Commenters disagree over what databases qualify as network elements under the 1996 Act. Some parties, including IXCs and other potential local competitors, argue that access to all incumbent LEC databases should be unbundled as network elements.[1044] This would include both incumbent LEC call processing and non-call processing databases.[1045] Most incumbent LECs counter that administrative or "back office" databases do not fall within the definition of network element in the 1996 Act.[1046] Incumbent LECs supporting this limited definition also argue that only those databases used for the routing and completion of calls are required to be unbundled by the 1996 Act.[1047]

[1041] SBC comments at 47; Sprint comments at 40 (currently provides access to its SS7 network through "A" signaling links which run from the end office to the STP and through "B" signaling links which connect the STPs of two separate SS7 networks); U S West comments at 48 (competitors should be able to provide their own transport to an STP or purchase transport from the incumbent LEC); PacTel comments at 58 (Pacific Bell proposed, before the California Commission, to unbundle its signaling links that provide interconnection between other carriers' switches or STPs to Pacific Bell's STPs).

[1042] SBC comments at 47.

[1043] SBC comments at 47.

[1044] ACSI comments at 42-44; AT&T comments at 23-26; ALTS comments at 31; MCI comments at 32-33.

[1045] ACSI comments at 42-44; ALTS comments at 31; MCI comments at 32-33 (both call processing and non-call processing databases necessary to route, complete and bill simple and complex calls should be unbundled as network elements).

[1046] Ameritech comments at 48-51; Bell Atlantic reply at 12-23; GTE reply at 21; Lincoln Tel. reply at 12; NYNEX reply at 34.

[1047] Bell Atlantic reply at 12-23; GTE reply at 21; Lincoln Tel. reply at 12; NYNEX reply at 34.

467. A number of parties urge the Commission to require incumbent LECs to provide competing carriers with the same access to their databases that they provide to themselves.[1048] Some potential local competitors argue that access to a number of existing incumbent LEC databases is important if they are to compete effectively with the incumbent LEC.[1049] Many parties, including most incumbent LECs, identify access to the Line Information Database (LIDB)[1050] and the Toll Free Calling (*i.e.*, 800, 888 numbers) database[1051] as important to the provision of local service.[1052] Some potential local competitors contend that databases are a significant expense and that they will be prohibitively costly to duplicate immediately or in the near future.[1053] The Louisiana Commission notes that it currently requires incumbent LECs to provide competitive providers with access to LIDB, Toll Free Calling, and AIN databases through signaling interconnection such that the functionality, quality, terms and conditions are equal to those the incumbent LEC provides to itself.[1054] Several incumbent LECs respond that they already provide such access to the LIDB and Toll Free Calling

[1048] ALTS comments at 31; ACSI comments at 42-43; MCI comments at 32-33; NCTA comments at 42 (competitors' customer information should be included in incumbent LEC databases on the same price, terms, and conditions as the incumbent LEC provides for itself); Teleport comments at 37; Wyoming Commission comments at 23 (nondiscriminatory access for call routing and completion); GCI comments at 13; LCI comments at 18; Vartec comments at 5.

[1049] ACSI comments at 42-43; MCI comments at 32-37. Letter from Leonard Sawicki, MCI Telecommunications to Robert Tanner, Common Carrier Bureau, FCC, July 3, 1996 (MCI July 3 *Ex Parte*). MCI identifies LIDB, Toll Free Calling, Local Number Portability and Directory Assistance databases as call processing databases necessary for new entrants to offer competitive local telephone service. *Id.*

[1050] Parties described the LIDB as a database containing information as to whether a subscriber number is a valid working line, telephone line type, call screening information and validation information for calling cards. *See* MCI July 3 *Ex Parte*. *See In the Matter of Local Exchange Carrier Line Information Database*, Report and Order, 8 FCC Rcd 7130 (1993).

[1051] Toll free calling (*i.e.*, 800, 888 numbers) is a nationwide service generally used to bill the called party. It utilizes a single national SMS and ten regional toll free calling SCP databases. Toll Free Calling SCPs are currently owned by Ameritech, Bell Atlantic, BellSouth, GTE, NYNEX, PacTel, SBC, SNET, Sprint (local), and U S West. The national SMS is owned by Bellcore and operated by a third party administrator. *See In the Matter of Toll Free Service Access Codes*, Notice of Proposed Rulemaking, 10 FCC Rcd 13692 (1995).

[1052] ACTA comments at 14; ALTS comments at 31; Ameritech comments at 47 (call routing and completion functions sometimes require supplemental calling functions or information such as 800 number routing data or credit verification); GTE comments at 24; U S West comments at 48; Bell Atlantic reply at 12-23; GTE reply at 18; NYNEX reply at 34.

[1053] AT&T comments at 23-24; NCTA comments at 42; Telecommunications Resellers Ass'n comments at 36.

[1054] Louisiana Commission comments at 5; *see* Michigan Commission comments at 12 (requires non-discriminatory access to databases necessary for the provision of local exchange service including LIDB and Toll Free Calling databases).

databases via their SS7 network.[1055] GVNW argues that all access to call-related databases must be mediated to prevent unauthorized messages from entering an incumbent's database.[1056]

468. Many potential local competitors argue that access to the incumbent LEC's LIDB should be unbundled.[1057] Most parties agree that query access to the LIDB is technically feasible.[1058] Most potential local competitors contend that they also need access to the incumbent LECs' administrative database (SMS) that is used to input customer data into the LIDB.[1059] AT&T argues that such access is technically feasible, and can be provided to competitors in the same manner that the incumbent LEC now does for itself.[1060] Other parties propose that the Commission require the incumbent LEC to input a competing carriers' customer information into its LIDB for the competitor.[1061]

469. Several parties argue that the Commission should unbundle the Toll Free Calling database for access by competitors.[1062] Most incumbent LECs commented that they already

[1055] Ameritech comments at 47; BellSouth comments at 43; GTE comments at 40; NYNEX comments at 71; Sprint comments at 40.

[1056] GVNW comment at 29; *see also* MECA comments at 38-39 (competitors should not have direct "on-line" access to incumbent databases).

[1057] ACTA comments at 14; ACSI comments at 42 (access to the LIDB is important to identify presubscribed interexchange carriers); GST comments at 25; ALTS comments at 31.

[1058] AT&T comments at 24; ALTS comments at 31; Ameritech comments at 46-51; Bell Atlantic comments at 27-28; GTE comments at 38-41; Louisiana Commission comments at 5; NCTA comments at 42; NYNEX reply at 34; Teleport comments at 37-38; U S West comments 48.

[1059] AT&T comments at 25-26; American Network Exchange comments at 5 (requesting access to LIDB, but without the current restrictions imposed by *In the Matter of Policies and Rules Concerning Local Exchange Carrier Validation and Billing Information for Joint Use Calling Cards*, CC Docket No. 91-115); ACSI comments at 42; Citizens Utilities comments at 15; NCTA comments at 42; Teleport comments at 37.

[1060] AT&T comments at 26. The conditions, (*e.g.*, type of media, electronic information transfer method) applicable to competitor interconnection with such databases should be identical to those the incumbent LEC uses for itself. *Id.*

[1061] Georgia Commission comments at 21 (under BellSouth-MCIMetro interconnection agreement, BellSouth will enter MCIMetro line information into its LIDB so as to enable MCIMetro customers to participate in alternative billing systems, such as collect calling and third number billing).

[1062] ALTS comments at 31; American Network Exchange comments at 5; ACSI comments at 43; Louisiana Commission comments at 5.

provide query access to their Toll Free Calling databases.[1063] In addition, access to the single national SMS is available under tariff administered by Bellcore.[1064]

470. Parties also argue that they need equal access to 911 and E911 services, including the underlying Automatic Location Indicator (ALI) database.[1065] Several state commissions have also asserted that such access is necessary for new entrants as well as incumbent LECs.[1066] NCTA asserts that competitors must have access to incumbent LEC systems for 911 and E911 services because currently only incumbent LECs maintain them.[1067]

471. Some competitive providers urge the Commission to require incumbent LECs to unbundle access to their AIN.[1068] Several parties argue that AIN should be unbundled to allow competitors to access the incumbent LEC's AIN physically at all points that the incumbent does for itself.[1069] Cable & Wireless argues that larger carriers may be able to design and build their own AIN technology, but smaller carriers may not be able to afford to

[1063] GTE comments at 40; Sprint comments at 40; NYNEX reply at 34. Reservation and activation of 800 and 888 numbers is available today as an unbundled tariff offering from many common carriers and independent suppliers through the RESP ORG process. *See In the Matter of Toll Free Service Access Codes*, Notice of Proposed Rulemaking, 10 FCC Rcd 13692 (1995).

[1064] Access to individual 800 and 888 numbers is achieved through the RESP ORG process administered by Bellcore. Customers contact a RESP ORG (which can be an IXC, LEC, wireless carrier, or a large organization like Westinghouse) which enters subscriber information into the 800 SMS, assigning a number to the subscriber. The SMS than loads the routing information into the SCPs, at which time the number is working and can be utilized by the subscriber. *See In the Matter of Toll Free Service Access Codes*, Notice of Proposed Rulemaking, 10 FCC Rcd 13692 (1995).

[1065] ACSI comments at 43; ALTS comments at 32; Citizens Utilities comments at 15; Comcast comments at 20; Continental comments at 19; GST comments at 25; MCI comments at 18, 33-34; NCTA comments at 42; Teleport comments at 37.

[1066] Georgia Commission comments at 19; Wyoming Commission comments at 23.

[1067] NCTA comments at 42.

[1068] Ad Hoc Telecommunications Users Committee comments at 24-25; ACTA comments at 18; ACSI at 42; Cable & Wireless comments at 23-25; CompTel comments at 43; GCI comments at 13; MCI comments at 33-34; Cable & Wireless reply at 23-24; USTN reply at 3-4. Letter from Genevieve Morelli, Vice President & general Counsel, CompTel to William Caton, Acting Secretary, FCC, June 14, 1996 (CompTel June 12 *Ex Parte*); Letter from Linda Oliver, Counsel for WorldCom to William Caton, Acting Secretary, FCC, June 14, 1996 (WorldCom June 14 *Ex Parte*).

[1069] CompTel comments at 43 (competitive providers should be able to interconnect with AIN elements at all points that ILECs interconnect currently); MCI comments at 35.

deploy all of the necessary equipment.[1070] MCI argues that access to the incumbent LEC's AIN capabilities would allow them to bring new services to the marketplace and enhance their ability to compete with the incumbent.[1071] Several commenters ask the Commission to adopt the approach of the Louisiana Commission which ordered unbundled access to incumbent LEC databases for all services that the incumbent LEC provides itself, including 800 number, LIDB, and AIN services.[1072] Sprint argues that access to AIN should be unbundled to the extent AIN is used by the incumbent LEC to provide call routing functions.[1073] Many incumbent LECs respond that AIN is still an evolving technology, and therefore it is not technically feasible for the Commission to require unbundled access.[1074] Some incumbent LECs also argue that AIN is not a signaling system or database, and therefore is not a network element under the Act.[1075]

472. A number of parties assert that currently the only technically feasible point of access to the incumbent LEC's AIN is at the incumbent LECs' SCE and SMS.[1076] Several competitive providers contend that access at the SCE and SMS would provide a competing carrier with the same ability to offer AIN-based services as the incumbent LEC without

[1070] Cable & Wireless comments at 23 (access to the incumbent LEC's existing AIN platform including the SMS database, signaling links and SCPs will allow new entrants to bring new services to the market efficiently and quickly).

[1071] MCI comments at 35.

[1072] ACSI comments at 43; CompTel comments at 43-44; MCI comments at 35 (competitive providers should stand in the same relationship to AIN components as the ILEC does when it offers AIN services to its customers).

[1073] Sprint reply at 20 n.27.

[1074] BellSouth comments at 44; SBC comments at 44; PacTel reply at 22 (*Intelligent Networks* docket contains evidence that AIN unbundling is not technically feasible).

[1075] Bell Atlantic comments at 29; Ameritech reply at 21 (arguing that because there are no services provided via AIN that are not also provided via the switch, that AIN unbundling is not necessary for competitive providers).

[1076] Ameritech comments at 49 (Ameritech claims that it has offered to provide database access via its SMS and SCE in the *Intelligent Networks* proceeding, but also argues that such access is still under development and not yet technically feasible); GTE comments at 42 (record in CC Docket No. 91-346 contains persuasive evidence that, other than access to the SMS, access to AIN network elements is neither technically nor operationally feasible at this time); Sprint comments at 41; Ameritech reply at 15 (agreeing with Sprint's position on SMS access); Bell Atlantic comments at 29-30 (as demonstrated in the *Intelligent Networks* docket, the only point at which it is technically feasible to provide AIN access is at the Service Management System level); LCI comments at 18-19.

having to recreate initially all of the AIN elements.[1077] Ericsson notes that mere unbundling of databases and signaling elements is not likely to allow competitors to create and offer competing AIN services unless they have access to both a service creation environment and service management system.[1078] Bell Atlantic asserts that AIN is not a network element within the scope of the 1996 Act, but allows that, if it were, unbundled access to the SMS should meet the requirements of section 251.[1079] BellSouth, however, contends that the Commission should not attempt to declare undefined "software building blocks" to be network elements.[1080] GVNW further argues that such access will require "partitioning" of incumbent LECs' databases to protect each carriers' information.[1081]

473. In our *Intelligent Networks* docket, several parties, including most incumbent LECs, expressed support for the Commission's proposal to require unbundled access to the SMS by third parties.[1082] Several parties argue that such access is technically feasible.[1083] Most incumbent LECs agree that, of the potential points of access to AIN proposed in our *Intelligent Networks* NPRM, access to the SMS poses the least risk of harm to the public

[1077] Ameritech comments at 49 (working on such access for third parties, although Ameritech believes it is not yet technically feasible); Bell Atlantic comments at 29 (access for third parties at the SMS would satisfy the requirements of section 251); Cable & Wireless comments at 24; Ericsson comments at 5-7; Sprint comments at 40 (access at the SMS is the only technically feasible point of interconnection for AIN that maintains network reliability); GVNW comments at 31 (competitor could create its own services in an incumbent LEC's SMS using the incumbent's SCE, which would protect the integrity of the incumbent LEC's AIN platform); LCI comments at 18 (SMS and SCE access are essential for competitors to provide advanced services).

[1078] Ericsson comments at 6.

[1079] Bell Atlantic comments at 29.

[1080] BellSouth comments at 46.

[1081] GVNW comments at 31.

[1082] *See, e.g.*, BellSouth update comments in CC Docket No. 91-346 at 6; Bell Atlantic comments in CC Docket No. 91-346 at 6; GTE comments in CC Docket No. 91-346 at 21; Central comments in CC Docket No. 91-346 at 12; SNET comments in CC Docket No. 91-346 at 5; NYNEX comments in CC Docket No. 91-346 at 3 n.3, 10-11; Siemens comments in CC Docket No. 91-346 at 2; TIA comments in CC Docket No. 91-346 at 2; MCI comments in CC Docket No. 91-346 at 10; Ericsson reply in CC Docket No. 91-346 at 2-3.

[1083] MCI comments in CC Docket No. 91-346 at 6; Siemens comments in CC Docket No. 91-346 at 2; TIA comments in CC Docket No. 91-346 at 2.

switched network.[1084] Many of these commenters argue that access to the SMS would provide competitors with an opportunity to create innovative call processing services.[1085] U S West, however, contends that, since third parties using SMS access would be dependent on incumbent LEC software at the SCE, competitors would not be satisfied with such access because it would not allow them to develop their own proprietary services.[1086] Other parties argue that SMS access will not provide significant benefits to third parties because of the limitations inherent in the service creation parameters established by the LECs.[1087]

474. Several parties argue that incumbent LEC SCP databases and AIN triggers in the incumbent LEC switch should be unbundled for a requesting carrier.[1088] Most incumbent LECs argue that sufficient mediation needs to be developed and implemented before any third party interconnection to AIN will be technically feasible.[1089] Some parties, however, counter that there is sufficient screening in the STP and that incumbent LECs should be required to accept AIN signaling messages from competitors' AIN SCP databases without additional mediation.[1090] AT&T argues that the refusal to carry AIN messages prevents competitive

[1084] Bell Atlantic comments in CC Docket No. 91-346 at 6-7; BellSouth comments in CC Docket No. 91-346 at 12, 13; GTE comments in CC Docket No. 91-346 at 19, 21; NYNEX comments in CC Docket No. 91-346 at 3; PacTel comments in CC Docket No. 91-346 at 20-21; SBC comments in CC Docket No. 91-346 at 5, 8; U S West comments in CC Docket No. 91-346 at 52; United and Central comments in CC Docket No. 91-346 at 1.

[1085] GSA comments in CC Docket No. 91-346 at 3; SNET comments in CC Docket No. 91-346 at 2; Siemens comments in CC Docket No. 91-346 at 2; TIA comments in CC Docket No. 91-346 at 2; MCI in CC Docket No. 91-346 comments at 10; Ericsson reply in CC Docket No. 91-346 at 2-3.

[1086] U S West comments in CC Docket No. 91-346 at 53; Ad Hoc Telecommunications Users Committee comments in CC Docket No. 91-346 at 11 (incumbent LECs' ability to mimic third party services created in the incumbent LEC's SCE will diminish the incentive of third parties to create new services that would co.npete with LEC AIN offerings).

[1087] AT&T comments in CC Docket No. 91-346 at 5-11 (competitors would be restricted to the particular LEC's AIN architecture and software platform, preventing the creation and deployment of unique AIN services); ALLNET comments in CC Docket No. 91-346 at 2; Ad Hoc Telecommunications Users Committee comments in CC Docket No. 91-346 at 8-9.

[1088] Ad Hoc Telecommunications Users Committee comments at 17; GCI at 12; Louisiana Commission at 5; LCI comments at 18.

[1089] BellSouth comments at 47. Mediation refers to additional screening software or devices to prevent incorrect or unacceptable AIN messages from reaching the switch or SCP database. *Id.*

[1090] ACTA comments at 21 (mediation devices will increase post dial delay and significantly increase competitors costs); CompTel comments at 45 (since section 251 unbundling is limited to telecommunications carriers, who already adhere to network security and integrity requirements as well as rigorous testing procedures, there is no need for mediation for access to AIN elements).

carriers from offering the same advanced AIN and CLASS services as the incumbent.[1091] AT&T further contends that mediation will not be necessary, because just as carriers are certified before interconnecting with other carriers' SS7 networks, carriers can be certified for AIN.[1092] Some competitors argue that a short transitional period of mediated access could be established to allow time for the adoption of standards to ensure network integrity, but only if incumbent LECs were required to use the same mediated access.[1093]

475. A few parties, including AT&T and MCI, propose unbundling of AIN in order to allow competing carriers to interconnect their own SCP database to the incumbent LECs' AIN so that competing carriers could provide call processing instructions to the incumbent LEC's switch for calls to or from its own customers.[1094] AT&T argues that this would allow it to offer different services to the customer than does the incumbent LEC, which would increase competition in the local exchange market.[1095] Ericsson admits that this is "an attractive concept which might increase competition" but argues that there are numerous technical issues that must be resolved, including billing and service interaction issues.[1096] Incumbent LECs, manufacturers and other parties argue that it is not technically feasible for a competing provider to connect its own alternative call processing database to the incumbent

[1091] AT&T reply at 20 (arguing that such a refusal violates the requirement of section 251(c)(2) for interconnection on "just, reasonable and nondiscriminatory" terms).

[1092] *See* Letter in CC Docket No. 91-346 from Bruce Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, Aug. 21, 1995 (*AT&T Intelligent Networks Proposal*) Attachment at 2; *but see* PacTel reply at 22 (certification would not prevent competitors from sending erroneous messages to an incumbent LEC's AIN SCP which could lead to unauthorized changes in a customer's service or PIC).

[1093] Cable & Wireless comments at 25; MCI comments at 36; ACSI comments at 44.

[1094] ACTA comments at 21; AT&T comments at 23-25; Cable & Wireless comments at 24; MCI comments at 18, 33 (arguing that such interconnection is supported by the findings of the Information Industry Liaison Committee (IILC) Issue #026 Task Force on Long Term Unbundling); CompTel comments at 44; AT&T reply at 19-20.

[1095] AT&T comments at 23-25. AT&T admits that this arrangement would require carriers to agree upon an expanded signaling message set for AIN call processing, but it argues that such messages are already defined by Bellcore and it is the refusal of incumbent LECs' to accept them that prevents its deployment. *Id.*

[1096] Ericsson comments at 6.

LEC signaling network.[1097] Many parties, including virtually all incumbent LECs, argue against allowing a competing carrier or reseller to connect its own alternative call processing database directly to the incumbent LEC's SS7 network because of the network reliability and security issues it creates.[1098] These parties warn that requiring such unbundled access to AIN could make an incumbent LEC's switch vulnerable to inappropriate routing and billing instructions from the competitor's SCP.[1099] BellSouth argues that the *Intelligent Networks* docket supports a finding that this type of AIN unbundling is not technically feasible.[1100] Sprint contends that it could not forecast capacity needs for a competing carrier's alternative database in order to identify its own network capacity requirements.[1101] GVNW adds that any national rule requiring such a form of interconnection would require many small incumbent LECs to make uneconomic upgrades of their switches in order to accommodate it.[1102]

[1097] Sprint comments at 41 (there are significant network reliability issues involved with introducing a third party database to an SS7 network); BellSouth comments at 46 (before interconnection of a third-party database to an incumbent LEC's signaling system, more development is still needed for routing, protocol screening, call gapping, resource contention, overload control, feature interaction management and billing concerns for such an arrangement); Ericsson comments at 6 (interconnection of a third-party database to an incumbent LEC's signaling system might promote competition but there are complex technical issues to address before such a scheme could become technically feasible); Teleport comments at 37-38.

[1098] BellSouth comments at 45-46 (introduction of a third-party database to an incumbent LEC's signaling system creates the potential for fraud, sabotage, and slamming of the incumbent LEC's customers); SBC comments at 45 (record in CC Docket No. 91-346 is replete with evidence demonstrating the current technical infeasibility of interconnection of third-party databases to an incumbent LEC' signaling system); Sprint comments at 41 (cannot test for system validation and feature interaction); Teleport comments at 37-38; GVNW comments at 30-31 (such interconnection must be mediated to protect both networks from potential harm from incorrect SS7 messages).

[1099] BellSouth comments at 46; Ericsson comments at 6; TCG comments at 37-38; GTE reply at 21-22 (third-party access to AIN triggers not technically feasible without mediation because of network reliability and service integrity issues); Teleport comments at 37-38; *but see* Cable & Wireless comments at 24 (incumbent LEC arguments concerning network integrity are analogous to AT&T arguments in *Carterfone* that non-Bell System equipment could cause malfunctions in the network).

[1100] BellSouth comments at 45-46 (areas still needing resolution include routing, protocol screening, call gapping, resource contention, overload control, feature interaction management, and billing). *See also* Letter in CC Docket No. 91-346 from Karen Weis, Division Manager, AT&T, and Ben G. Almond, Executive Director, Federal Regulatory, BellSouth, to William F. Caton, Acting Secretary, FCC, Dec. 14, 1995 (*AT&T-BellSouth Intelligent Networks Joint Report*). The *AT&T-Bell South Intelligent Networks Joint Report* detailed the results of their laboratory-to-laboratory test concerning the interconnection of an AT&T SCP to BellSouth's SSP. *Id.*

[1101] Sprint comments at 41.

[1102] GVNW comments at 30-31.

476. Many parties contend that further testing of AIN is needed before further access and interconnection between carriers can be considered technically feasible.[1103] Most of the BOCs support a two year testing plan for the industry to further investigate issues relating to AIN before moving forward to third party interconnection.[1104] Several parties, however, urge the Commission to reject the LECs' proposed *Intelligent Networks* testing plan, argue that it is not necessary to ensure network integrity and that it is inconsistent with the 1996 Act.[1105] Parties opposed to the LECs' testing plan assert that it is vague and revisits work that has already been done in existing industry fora.[1106] Supporters of the LECs' testing plan, however, counter that they are willing to consider working within existing industry fora.[1107] As described in the *Intelligent Networks* docket, the LEC testing plan will take place over a two year period with final recommendations to be decided by the participants themselves. Some competitors, while allowing for the need for further testing, advocate imposing a mandatory time limit on the resolution of the outstanding mediation issues for unbundled access to AIN.[1108]

477. Some commenters believe that a Commission order to unbundle AIN functionalities would satisfy the objectives of the *Intelligent Networks* proceeding.[1109] AT&T

[1103] Bell Atlantic comments at 29 n.10; BellSouth comments at 47; Ericsson comments at 6-7; GTE comments at 42; GVNW comments at 32; Lincoln Tel. comments at 10; SBC comments at 46; U S West comments at 58.

[1104] Bell Atlantic comments at 29 n.10; BellSouth comments at 47; GTE comments at 42; Lincoln Tel. commeats at 10; SBC comments at 44 (Commission should issue order in CC Docket No. 91-346 that endorses the Tier 1 LECs' joint proposal for an industry IN project); U S West comments at 58 (industry testing plan will lead to development of non-proprietary AIN interfaces). *See* Letter in CC Docket No. 91-346 from Sandra Wagner, Director, Federal Regulatory, SBC Communications, Inc., to William F. Caton, Acting Secretary, FCC, June 23, 1995 (*LEC Intelligent Networks Proposal*). Active participants in the LEC Proposal are Bell Atlantic, GTE, PacTel, SBC and U S West. Other incumbent LECs supporting the LEC Proposal, but not currently "active" include BellSouth, Lincoln Tel., SNET, and Sprint.

[1105] Cable & Wireless comments at 26; MCI comments at 36-37. *See also* AT&T update comments in Docket 91-346 at 5-6.

[1106] MCI comments at 36-37; *but see* GTE reply at 22 (testing is necessary and is not intended for delay).

[1107] Letter in CC Docket No. 91-346 from Sandra Wagner, Director, Federal Regulatory, SBC Communications, to William Caton, Acting Secretary, FCC, May 22, 1996 (SBC May 22 *Intelligent Networks Ex Parte*). SBC contends that the Joint LEC project proposed creating a new forum directly in response to MCI's prior assertions that ATIS sponsored forums were ineffective in addressing interconnection issues. *Id.* at 4-5.

[1108] Cable & Wireless comments at 25; MCI comments at 36 (advocating that the Commission refer outstanding issues from the IILC Issue #026 consensus document to an established forum and that it should monitor progress to ensure implementation of access to the remaining interface points is accomplished within six months of the end of an initial negotiation or arbitration process).

[1109] AT&T comments at 25 n.29; Cable & Wireless comments at 26.

asserts that, if unbundled signaling explicitly includes the exchange of AIN signaling messages between incumbent LEC switches and competitor's SCPs, then the Commission does not need to pursue CC Docket No. 91-346 further because its objectives will be met in this proceeding.[1110] SBC, however, urges the Commission not to merge the *Intelligent Networks* proceeding into this docket.[1111]

c. Discussion

478. In the interconnection section above, we conclude that the exchange of signaling information between LECs necessary to exchange traffic and access call related databases was included within the interconnection obligation of section 251(c)(2).[1112] Thus, notwithstanding any obligations under section 251(c)(3), incumbent LECs are required to accept and provide signaling in accordance with the exchange of traffic between interconnecting networks. We conclude that this exchange of signaling information may occur through an STP-to-STP interconnection.

(1) Signaling Links and STP

479. We conclude that incumbent LECs, upon request, must provide nondiscriminatory access to their signaling links and STPs on an unbundled basis. We believe it is technically feasible for incumbent LECs to provide such access, and that such access is critical to entry in the local exchange market. Further, the 1996 Act requires BOCs to provide "nondiscriminatory access to databases and associated signaling necessary for call routing and completion" as a precondition for entry into in-region interLATA services.[1113] Thus, it appears that Congress contemplated the unbundling of signaling systems as network elements.

[1110] AT&T comments at 25 n.29.

[1111] SBC comments at 46 (arguing that record in CC Docket No. 91-346 is already complete).

[1112] *See supra*, Section IV. We emphasize, in Section V.J.4.c.(4), such exchange of signaling information does not include the exchange of AIN signaling information between networks for the purpose of providing AIN messages to the incumbent LEC's switch from a competitor's SCP database.

[1113] 47 U.S.C. § 271(c)(2)(B)(x). *See also* statement of Sen. Pressler, noting that "access to signaling and databases [is] important if you are going to compete and get into the market." 141 Cong. Rec. S8163 (June 12, 1995).

480. We conclude that access to unbundled signaling links and STPs is technically feasible.[1114] The majority of commenters, including incumbent LECs, agree that it is technically feasible to provide unbundled access to signaling links and STPs.[1115] Parties note that incumbent LECs and signaling aggregators already provide such access.[1116] In addition, several state commissions already require incumbent LECs to provide unbundled elements of SS7 networks.[1117] Because of the screening role played by the STP and associated network reliability concerns that were raised in the record, however, we do not require that incumbent LECs permit requesting carriers to link their own STPs directly to the incumbent's switch or call-related databases.[1118] We take a deliberately conservative approach here because of significant evidence in the record and we note that mere conclusory objections to technical feasibility would not alone be sufficient evidence.

481. Under section 251(d)(2)(A), the Commission must consider whether access to proprietary network elements is necessary.[1119] Commenters did not identify proprietary concerns with signaling protocols for the SS7 network.[1120] Moreover, in general, SS7 signaling networks adhere to Bellcore standards, rather then LEC-specific protocols and provide seamless interconnectivity between networks.[1121] Thus, we conclude that the

[1114] As discussed *infra*, we conclude that it is not technically feasible to unbundle the SCP from its associated STP, therefore, we do not require incumbent LECs to unbundle those signaling links connecting SCPs to STPs. We emphasize that we take this conservative course here because of the real evidence in the record and note that mere conclusory objections to technical feasibility will not be considered sufficient evidence of such.

[1115] *See, e.g.*, AT&T comments at 23; TIA comments at 14; U S West comments at 48; PacTel reply at 21-22.

[1116] *See, e.g.*, BellSouth comments at 43; GVNW comments at 29; NYNEX comments at 71; USTN reply at 1.

[1117] *See, e.g.*, Colorado Commission comments at 24; Michigan Commission comments at 12; Texas Commission comments at 19.

[1118] *See, e.g.*, Ameritech comments at 50; Bell Atlantic comments at 27; MCI comments at 34-35; Sprint comments at 40. We note, however, that we do not preempt those state commissions that have required incumbent LECs to do so. *See Illinois Wholesale Order*.

[1119] 47 U.S.C. § 251(d)(2)(A).

[1120] AT&T argues that there are no proprietary information issues because signaling information is generated in the incumbent LEC's switch and is provisioned entirely by the incumbent LEC. AT&T comments at 26.

[1121] A few commenters urge that we prohibit incumbent LECs from taking a proprietary interest in signaling protocols. These parties argue that such a proprietary interest conflicts with the continuing necessity for open access to signaling protocols to maintain the seamless nationwide "network of networks." *See* Frontier comments at 16 n.31; Wyoming Commission comments at 24.

unbundling of signaling links and STPs does not present proprietary concerns with respect to the incumbent LEC.

482. Under section 251(d)(2)(B), the Commission must consider whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[1122] Access to signaling systems continues to be a critical element to providing competing local exchange and exchange access service. The vast majority of calls made over incumbent LEC networks are set-up and controlled by separate signaling networks. Incumbent LECs argue that access to signaling systems and associated databases is already available from other providers and therefore, they should not have to unbundle them for access by competitors.[1123] As discussed above, section 251(d)(2)(B) only relieves an incumbent LEC of its unbundling obligation if other unbundled elements in its network could provide the same service without diminution of quality. Because alternative signaling methods, such as in-band signaling, would provide a lower quality of service,[1124] we conclude that a competitor's ability to provide service would be significantly impaired if it did not have access to incumbent LECs' unbundled signaling links and STPs.

483. The purchase of unbundled elements of the SS7 network gives the competitive provider the right to use those elements for signaling between its switches (including unbundled switching elements), between its switches and the incumbent LEC's switches, and between its switches and those third party networks with which the incumbent LEC's SS7 network is interconnected. When a competitive provider purchases unbundled switching from the incumbent LEC, the incumbent LEC must provide nondiscriminatory access to its SS7 network from that switch in the same manner in which it obtains such access itself. Carriers that provide their own switching facilities should be able to access the incumbent LEC's SS7 network for each of their switches via a signaling link between their switch and an incumbent

[1122] 47 U.S.C. § 251(d)(2)(B).

[1123] *See, e.g.*, Bell Atlantic comments at 27-28; BellSouth comments at 44; GTE comments at 40-41; NYNEX comments at 71.

[1124] SS7 network signaling is critical in the provision of modern telecommunications services, allowing signaling messages to travel separately from the voice path for individual calls, increasing efficiency and making possible a host of new signaling-based services. AT&T comments at 23. Popular features like Calling Number Identification (Caller ID) and Calling Name Identification, as well as enhanced call set-up functions and such Custom Calling features as Repeat Call and Return Call, would be unavailable without SS7 capabilities. Bell Atlantic comments at Attachment 3, 17.

LEC's STP.[1125] Competitive carriers should be able to make this connection in the same manner as an incumbent LEC connects one of its own switches to the STP. This could be accomplished by the incumbent providing an unbundled signaling link from its STP to the competitor's switch or by a competitor bringing a signaling link from its switch to the incumbent LEC's STP.

(2) Call-Related Databases

484. We conclude that incumbent LECs, upon request, must provide nondiscriminatory access on an unbundled basis to their call-related databases[1126] for the purpose of switch query and database response through the SS7 network.[1127] Thus, for example, we find that it is technically feasible for incumbent LECs to provide access to the Line Information Database (LIDB), the Toll Free Calling Database and Number Portability downstream databases.[1128] The vast majority of parties, including incumbent LECs, agree that it is technically feasible to provide access to the LIDB and the Toll Free Calling databases at an STP linked to the database.[1129] Several state commissions also report that they have ordered incumbent LECs' to provide such access to the LIDB and the Toll Free Calling

[1125] Competitors should be able to interconnect their own switches to the incumbent LEC's signaling system in any technically feasible manner. Competitors may bring a signaling "A" link from their switch to the incumbent LEC's STP. CAPs use this type of connection today to connect their tandem switches to incumbent LECs' STPs. AT&T comments at 24 n.26. Competitors might also link their switch to their own STP, and then connect to an incumbent LEC's STP via a signaling "D"or "B" link.

[1126] Call-related databases are those SS7 databases used for billing and collection or used in the transmission, routing, or other provision of a telecommunications service.

[1127] Query and response access to a call-related database is intended to require the incumbent LEC only to provide access to its call-related databases as is necessary to permit a competing provider's switch (including the use of unbundled switching) to access the call-related database functions supported by that database. The incumbent LEC may mediate or restrict access to that necessary for the competing provider to provide such services as are supported by the database.

[1128] AT&T indicates that for LIDB and 800/888 database queries standard TCAP messages have been established, and reliability, security, provisioning, and billing issues have been addressed. Letter from Karen Weis, Division Manager, AT&T to William Caton, Acting Secretary, FCC, July 16, 1996 (AT&T July 16 *Ex Parte*). Bell Atlantic states that it currently provides interconnection for LIDB and 800 databases. Bell Atlantic comments at 2. Number portability "downstream databases" are defined in Part 51 of our rules as adopted by this Order. *See In the Matter of Telephone Number Portability*, First Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 95-116, FCC 96-286 (rel. July 2, 1996).

[1129] *See, e.g.*, Ameritech comments at 47; AT&T comments at 24; ALTS comments at 31; GTE comments at 40; MCI comments at 34-35; NYNEX comments at 71; U S West comments at 48.

databases.[1130] We require incumbent LECs to provide this access to their call-related databases by means of physical access at the STP linked to the unbundled database. We find that such access is critical to entry in the local exchange market.

485. We conclude that it is not technically feasible to unbundle the SCP from its associated STP. We note that the overwhelming majority of commenters contend that it is not technically feasible to access call-related databases in a manner other than by connection at the STP directly linked to the call-related database.[1131] Parties argue that the STP is designed to provide mediation and screening functions for the SS7 network that are not performed at the switch or database.[1132] We, therefore, emphasize that access to call-related databases must be provided through interconnection at the STP and that we do not require direct access to call-related databases.

486. Several commenters also identified access to call-related databases used in the incumbent's AIN to be critical to fair competition in the local market,[1133] and some state commissions have ordered incumbent LECs to provide access to AIN databases.[1134] We conclude that such access is technically feasible via an STP for those call-related databases used in the incumbent LEC's AIN.[1135] First, of course, when a new entrant purchases an incumbent's local switching element it is technically feasible for the new entrant to use the incumbent's SCP element in the same manner, and via the same signaling links, as the incumbent itself. Thus, we find no technical impediments in the record with regard to such access when a requesting carrier is also purchasing a local switching element associated with the AIN call-related database.

[1130] Louisiana Commission comments at 5; Michigan Commission comments at 12; PacTel comments at Appendix A, 7 (California Commission has required such access).

[1131] *See, e.g.*, Sprint comments at 40; AT&T reply at 19-20 n.32.

[1132] *See, e.g.*, GTE comments at 40; USTA comments at 36.

[1133] Cable & Wireless comments at 24; Citizens Utilities comments at 15; MCI comments at 32-33; TIA comments at 14; CompTel comments at 43; AT&T comments at 23-26.

[1134] Louisiana Commission comments at 5; Wyoming Commission comments at 23-24; *see also Illinois Wholesale Order*.

[1135] AT&T comments at 23-26; CompTel comments at 43; MCI comments at 36; Letter from Wendy Blueming, Regulatory Affairs and Public Policy, SNET to William Caton, Acting Secretary, FCC, July 23, 1996 (SNET July 23 *Ex Parte*); AT&T July 16 *Ex Parte*.

487. Further, we conclude that when a new entrant deploys its own switch, and links it to the incumbent LEC's signaling system, it is technically feasible for the incumbent to provide access to the incumbent's SCP to provide AIN-supported services to customers served by the new entrant's switch. Some SS7 network services resellers currently provide such access.[1136] Other potential local competitors present additional evidence supporting the technical feasibility of such access.[1137] Unlike the situation where a competitor's SCP would control the incumbent's switch (which is discussed below in section V.I.4.c.(4)), in this scenario, the incumbent's SCP will respond to and control the competitor's switch, and potential competitors that have commented in the record do not express network reliability concerns with regard to such control.[1138] Further, like the software resident in a switch, the incumbent LEC's applications resident in an SCP are merely part of the overall software and hardware making up the SCP facility. Thus, carriers purchasing access under either scenario above may use the incumbent's service applications in addition to their own.[1139]

488. Although we conclude that access to incumbent AIN SCPs is technically feasible, we agree with BellSouth that such access may present the need for mediation mechanisms to, among other things, protect data in incumbent AIN SCPs and ensure against excessive traffic volumes.[1140] In addition, there may be mediation issues a competing carrier

[1136] SNET July 23 *Ex Parte*; Letter from Stephen Kraskin, Illuminet (USTN) to Office of the Secretary, FCC July 23, 1996 (USTN July 23 *Ex Parte*).

[1137] *See* AT&T July 16 *Ex Parte*; *see also* AT&T comments at 23-26; CompTel comments at 43; MCI comments at 36.

[1138] *See* AT&T July 16 *Ex Parte*. AT&T asserts that no additional or unique reliability problems would be created that have not already been addressed and resolved by those incumbent LECs who have proposed SMS access for third parties in the Intelligent Networks proceeding. *Id.*

[1139] *See infra*, Section V.I.4.c.(3) on unbundled access to the incumbent LEC's SCE and SMS.

[1140] Letter from W.W. Jordan, Executive Director - Federal Regulatory, BellSouth to William Caton, Acting Secretary, FCC, July 16, 1996 (BellSouth July 16 *Ex Parte*) ("With a BellSouth SCP to a ALEC SSP [switch] interconnection arrangement, network reliability and security concerns, from BellSouth's perspective, would largely be limited to issues associated with traffic management."); Letter from James Smith, Director--Federal Relations, Ameritech to William Caton, Acting Secretary, FCC, July 17, 1996 (Ameritech July 17 *Ex Parte*) ("The volume of queries sent from the CLEC SSP [switch] could overload the LEC SCP, interfering with the operation of the service provided to that CLEC, or with other services which may operate on the LEC's SCP."); Letter from Joseph Mulieri, Director--FCC Relations, Bell Atlantic to Robert S. Tanner, Attorney Advisor, FCC, July 18, 1996 (Bell Atlantic July 18 *Ex Parte*). BellSouth also raises the need for mediation to prevent unauthorized modification of information within an incumbent LEC's AIN SCP database. BellSouth July 16 *Ex Parte*. Incumbent LECs' comments in this proceeding and in the IN docket generally focus on the need for mediation to prevent a competitor's database from sending inappropriate AIN signaling information to the incumbent LEC's switch (*see infra* Section V.I.4.c.(4)). *See* PacTel comments at 61-62; BellSouth comments at 45-46; Bell Atlantic comments at Appendix 3, 18-19; U S West comments in CC Docket No. 91-346 at 73-74, 84; NYNEX comments in CC Docket No. 91-346 at 14-15; SBC comments in CC Docket No. 91-346 at 8-9.

will need to address before requesting such access.[1141] Accordingly, if parties are unable to agree to appropriate mediation mechanisms through negotiations, we conclude that during arbitration of such issues the states (or the Commission acting pursuant to section 252(e)(5)) must consider whether such mediation mechanisms will be available and will adequately protect against intentional or unintentional misuse of the incumbent's AIN facilities. We encourage incumbent LECs and competitive carriers to participate in industry fora and industry testing to resolve outstanding mediation concerns.[1142] Incumbent LECs may establish reasonable certification and testing programs for carriers proposing to access AIN call related databases in a manner similar to those used for SS7 certification.[1143]

489. We recognize that providing unbundled access to AIN call-related databases at cost, and in particular providing access to the incumbent LEC's software applications that reside in the AIN databases, may reduce the incumbent's incentive to develop new and advanced services using AIN. In the near term, however, requiring entrants to bear the cost of deploying a fully redundant network architecture, including AIN databases and their application software, would constitute a significant barrier to market entry for competitive carriers. As local service markets develop, however, competition may reduce the incumbent LEC's control over bottleneck facilities and increase the importance of innovation. In those circumstances it is important that incumbent LECs have the incentive to develop unique and innovative services supported by AIN. Therefore at a later date, we will revisit the proper balance between providing unbundled access and maintaining the incentives of incumbent LECs to innovate.

490. Parties generally do not identify proprietary concerns when access to call-related databases is provided via STPs. In general, signaling protocols used to access call-related databases adhere to open Bellcore standards. Parties also do not raise proprietary concerns with specific call-related databases themselves. Today, many separate carriers access incumbent LEC Toll Free Calling and LIDB databases for the proper routing and billing of calls.[1144] Thus, we conclude that, in general, unbundled access to call-related databases does not present proprietary concerns with respect to section 251(d)(2)(A). Incumbent LECs may,

[1141] Mediation may be necessary for requesting carriers to ensure that inadvertent feature interactions, network management control and customer privacy concerns do not arise from such access. *See e.g.*, Ameritech July 17 *Ex Parte*.

[1142] *See, e.g.*, Christine Maglott, *Information Industry Liaison Committee Wrestles with Mediation Issues*, ATIS News, 3, Vol. 11, No.3, May-June, 1996.

[1143] SBC notes that carriers proposing to gain access to its SS7 network and gather information from its SCP must be certified and enter into contractual agreements for information access and proper billing. SBC comments at 47-48.

[1144] *See* AT&T July 16 *Ex Parte*.

however, present such proprietary concerns in the arbitration process with regard to specific databases, and states (or the Commission acting pursuant to section 252(e)(5)) may take action to limit unnecessary access to proprietary information.

491. We also conclude that denying access to call-related databases would impair the ability of a competing provider to offer services such as Alternative Billing Services and AIN-based services. AIN-based services represent the cutting edge of telephone exchange services, and competitors would be at a significant disadvantage if they were forced to develop their own AIN capability immediately. In addition, the record indicates that deployment of call-related databases in the near term would represent a substantial cost to new entrants. As mentioned above, incumbent LECs argue that access to certain call-related databases is already competitively available and therefore they should not have to unbundle access to them.[1145] As discussed above, however, section 251(d)(2)(B) would only relieve an incumbent LEC of its unbundling obligation if other unbundled elements in its network could provide the same service without diminution of quality. Because of the absence of such elements, we conclude that a competitor's ability to provide service would be significantly impaired if it did not have unbundled access to incumbent LECs' call-related databases, including the LIDB, Toll Free Calling, AIN, and number portability downstream databases for the purpose of switch query and database response through the SS7 network.

492. We also conclude that access to call-related databases as discussed above, and access to the service management system discussed below, must be provided to, and obtained by, requesting carriers in a manner that complies with section 222 of the Act. Section 222, which was effective upon adoption, sets out requirements for privacy of customer information. Section 222(a) provides that all telecommunications carriers have a duty to protect the confidentiality of proprietary information of other carriers, including resellers, equipment manufacturers, and customers. Section 222(b) requires that telecommunications carriers that use proprietary information obtained from another telecommunications carrier in providing any telecommunications service "shall use that information only for such purpose, and shall not use such information for its own marketing purposes."[1146] Sections 222(c) and (d) provide protection for, and limitations on the use of, and access to, customer proprietary network

[1145] We note that competitive provision of AIN SCP database services is not evidenced in the record.

[1146] 47 U.S.C. § 222(b).

information (CPNI).[1147] We note that we have initiated a proceeding to clarify the obligations of carriers with regard to section 222(c) and (d).[1148]

(3) Service Management Systems

493. Finally, we conclude that incumbent LECs should provide access, on an unbundled basis, to the service management systems (SMS), which allow competitors to create, modify, or update information in call-related databases. We believe it is technically feasible for incumbent LECs to provide access to the SMS in the same manner and method that they provide for their own access. We find that such access is necessary for competitors to effectively use call-related databases, which we have already found to be critical to entry in the local exchange market.

494. Commenters argue that they need equal access to incumbent LECs' SMSs to write or populate their own information in call-related databases.[1149] As discussed above, information bound for many call-related databases is entered first at an off-line SMS, which then downloads the information to the call-related database for real time use on the network. We find that competing provider access to the SMS is technically feasible if it is provided in the same or equivalent manner that the incumbent LEC currently uses to provide such access to itself.[1150] For example, if the incumbent LEC inputs information into the SMS using magnetic tapes, the competitive carrier must be able to create and submit magnetic tapes for the incumbent to input into the SMS in the same way the incumbent inputs its own magnetic tapes. If the incumbent accesses the SMS through an electronic interface, the competitive carrier should be able to access the SMS through an equivalent electronic interface.[1151] We further conclude that, whatever method is used, the incumbent LEC must provide the

[1147] Section 222(f)(1) defines CPNI as "information that relates to the quantity, technical configuration, type, destination, and amount of use of a telecommunications service subscribed to by any customer of a telecommunications carrier, and that is made available to the carrier by the customer solely by virtue of the carrier-customer relationship." 47 U.S.C. § 222(f)(1)(A).

[1148] *See Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and other Customer Information*, Notice of Proposed Rulemaking, CC Docket No. 96-115, FCC 96-221 (rel. May 17, 1996).

[1149] AT&T comments at 26; MCI comments at 34-35.

[1150] Many carriers currently submit such information to incumbent LECs or third party SMSs. USTN reply at 1-4; Bell Atlantic comments at Attachment 3, 16; GTE comments at 40-41 n.61.

[1151] For example, access to the AIN SMS is accomplished through the SCE, which is a computer environment for the design and test of AIN based services.

competing carrier with the information necessary to correctly enter or format for entry the information relevant for input into the particular incumbent LEC SMS.

495. Specifically with respect to AIN, we find that the record in the *Intelligent Networks* proceeding supports access to the SMS.[1152] A competing carrier seeking access to the SMS that is part of the incumbent LEC's AIN would do so through the incumbent LEC's service creation environment (SCE), an interface used to design, create, and test AIN supported services. Software successfully tested in the SCE is transferred to the SMS, where it is then downloaded into an SCP database for active deployment on the network. We are persuaded that the risk of harm to the public switched network from such access to the SMS is minimized by the technical safeguards inherent in the SCE and SMS. As described in comments filed in the *Intelligent Networks* docket, competitors accessing the SCE and SMS would not communicate directly with the LEC's database or switch.[1153] We therefore conclude that such access is technically feasible, and that incumbent LECs should provide requesting carriers with the same access to design, create, test, and deploy AIN-based services at the SMS that the incumbent LEC provides for itself.[1154] While many incumbent LECs express concerns with the technical feasibility of access to AIN, we conclude that those

[1152] *See Intelligent Networks*, Notice of Proposed Rulemaking, 8 FCC Rcd 6813 (1993). In the *Intelligent Networks* proceeding, most incumbent LECs supported SMS access. *See* GTE comments in CC Docket No. 91-346 at 21; United and Central comments in CC Docket No. 91-346 at 12; SNET comments in CC Docket No. 91-346 at 5; NYNEX comments in CC Docket No. 91-346 at 3 n.3, 10-11; BellSouth update comments in CC Docket No. 91-346 at 6; Bell Atlantic comments in CC Docket No. 91-346 at 6. Other parties, including potential competitors and manufacturers, also supported SMS access. *See* Siemens comments in CC Docket No. 91-346 at 2; TIA comments in CC Docket No. 91-346 at 2; MCI comments in CC Docket No. 91-346 at 10; Ericsson reply in CC Docket No. 91-346 at 2-3. Many commenters asserted that SMS access through the SCE would provide a valuable opportunity for third parties to create services. *See* GSA comments in CC Docket No. 91-346 at 3; SNET comments in CC Docket No. 91-346 at 2; Siemens comments in CC Docket No. 91-346 at 2; Ericsson reply in CC Docket No. 91-346 at 2-3; TIA comments in CC Docket No. 91-346 at 2; MCI comments in CC Docket No. 91-346 at 10.

[1153] In their comments, BellSouth and Bell Atlantic describe the way they provide or plan to provide access to the SMS for third parties. Bell Atlantic proposes to first develop and deploy AIN services based on customer request and then subsequently to allow third parties themselves to create AIN services at a terminal either in a Bell Atlantic office or a third party office. Bell Atlantic comments in CC Docket No. 91-346 at 6. BellSouth proposes to permit third parties to use the service logic resident on BellSouth's service creation environment to create AIN services. BellSouth update reply in CC Docket No. 91-346 at 10.

[1154] Incumbent LECs that have deployed AIN must provide such access to competing carriers that will allow them to develop call processing applications pursuant to the same parameters the incumbent LEC uses itself, such as the time-of-day and origination of call parameters. BellSouth's recently proposed service to provide access to its SCE and SMS appears to be an example of the type of access to the SMS that incumbent LECs must provide to competitors upon request. *Pleading Cycle Established for Comments on BellSouth Telecommunications, Inc.'s Petition for Expedited Waiver of Part 69 Rules*, Public Notice, DA 96-27 (Jan. 17, 1996) (*BellSouth Part 69 Waiver Petition*).

concerns deal primarily with the interconnection of third party AIN SCP databases to the incumbent LEC's AIN and not access to the SCE and SMS.[1155]

496. We recognize that, although technically feasible, providing nondiscriminatory access to the SMS and SCE for the creation and deployment of AIN services may require some modifications, including appropriate mediation, to accommodate such access by requesting carriers. We note that BellSouth is currently prepared to tariff and offer such access to third parties, and other incumbent LECs, including Bell Atlantic and Ameritech, indicate that they have made significant progress towards implementing such access.[1156] Therefore, if parties are unable to agree to appropriate mediation mechanisms through negotiations, we conclude that during arbitration of such issues the states (or the Commission acting pursuant to section 252(e)(5)) must consider whether such mediation mechanisms will be available and will adequately protect against intentional or unintentional misuses of the incumbent's AIN facilities. We again encourage incumbent LECs and competitive carriers to participate in industry fora and industry testing to resolve outstanding mediation concerns.

497. Parties did identify some proprietary concerns regarding access to the SCE and SMS used in the incumbent LEC's AIN. Some incumbent LECs contend that the interface used at the SCE is proprietary in nature.[1157] GVNW argues that specific AIN-based services designed by carriers should be proprietary in nature.[1158] Competitors correctly argue that AIN can be used, not only for telecommunication services traditionally supported by the switch, but as a means to deploy advanced services not otherwise possible.[1159] We find that competing providers without access to AIN would be at a significant disadvantage to

[1155] Of the three potential points of access to AIN proposed in the *Intelligent Networks* NPRM, LEC commenters generally agree that SMS access poses the least risk of harm to the public switched telephone network. *See* Bell Atlantic comments in CC Docket No. 91-346 at 6-7; BellSouth comments in CC Docket No. 91-346 at 12, 13; GTE comments in CC Docket No. 91-346 at 19, 21; NYNEX comments in CC Docket No. 91-346 at 3; PacTel comments in CC Docket No. 91-346 at 20-21; SBC comments in CC Docket No. 91-346 at 5, 8; U S West comments in CC Docket No. 91-346 at 52; United and Central comments in CC Docket No. 91-346 at 1. Competitors also support such access. *See* MCI Comments at 6; Siemens Comments at 2; TIA Comments at 2.

[1156] *BellSouth Part 69 Waiver Petition*. BellSouth proposes to tariff services that permit third parties to create and administer AIN services through access to the SCE and SMS. Bell South's SCE/SMS service will support third-party service development with the following AIN triggers: off-hook immediate, off-hook delay, public office dialing plan, customized dialing plan, feature code and terminating attempt triggers. *Id.* *See* Bell Atlantic comments in CC Docket No. 91-346 at 6, 8; Ameritech July 17 *Ex Parte*.

[1157] U S West comments at 58 n.124 (for example, BellSouth uses DESIGNedge for such access which utilizes a proprietary database technology tailored to its network); Bell Atlantic comments at 28-29.

[1158] GVNW comments at 30 (incumbent LECs should be able to copyright AIN based services that they create or incumbents will have much less incentive to develop such services).

[1159] AT&T comments at 23-25; Cable & Wireless comments at 24; MCI comments at 18, 33.

incumbent LECs, because they could not necessarily offer the same services to the customer. This access will help competing providers without imposing costs on incumbent LECs because the entrants will pay the cost.[1160] We therefore conclude, under section 251(d)(2)(A), that access to AIN, including those elements that may be proprietary, is necessary for successful entry into the local service market.

498. Most parties generally did not identify proprietary concerns with access to those SMSs used other than for AIN. Some parties, however, argue that there are proprietary interfaces used to enter information into various databases.[1161] Competing carriers counter that competitive providers would not need to have direct access to the proprietary methods of data entry used by incumbent LECs, and as a result we conclude that the unbundled access to SMSs used for other than AIN does not present proprietary concerns with respect to section 251(d)(2)(A).[1162]

499. We also conclude that unbundled access to all SMSs is necessary for a competing provider to effectively use unbundled call-related databases. We find that the inability of competing carriers to use the SMS in the same manner that an incumbent LEC uses to input data itself would impair the ability of a competing carrier to effectively offer services to its customers using unbundled call-related databases. Commenters in the record point out that access to call-related databases alone would not allow the competing carrier to provide such services to its customers without access to an SMS.[1163] We also conclude that AIN-based services are important to a new entrant's ability to compete effectively for customers with the incumbent LEC, and in developing new business by introducing new AIN based services. Thus we conclude that a competitor's ability to provide service would be significantly impaired if it did not have unbundled access to an incumbent LEC's SMS, including access to the SMS(s) used to input data to the LIDB, Toll Free Calling, Number Portability and AIN call-related databases.

500. We reject the contention by several incumbent LECs that signaling and database access was meant by the 1996 Act to apply only to such access as is necessary for call routing and completion. Although the competitive checklist for BOC entry into in-region interLATA services under section 271 requires "nondiscriminatory access to databases and associated

[1160] *See supra*, Section VII.

[1161] AT&T June 13 *Ex Parte*.

[1162] AT&T comments at 26.

[1163] Ericsson comments at 6.

signaling necessary for call routing and completion"[1164] the definition of a network element is more comprehensive in scope. A network element as defined by the 1996 Act includes "databases" and in particular "databases sufficient for billing and collection or used in the transmission, routing, or *other* provision of a telecommunications service."[1165] We find that the inclusion of "other provision of a telecommunications service" meant Congress intended the unbundling of databases to be read broadly and could include databases beyond those directly used in the transmission or routing of a telecommunications service.

(4) Third Party Call-Related Databases

501. We find that there is not enough evidence in the record to make a determination as to the technical feasibility of interconnection of third party call-related databases to the incumbent LEC's signaling system. Some parties argue that such interconnection, including the interconnection of third party AIN SCP databases, would allow them to provide more efficient or advanced call processing and services to customers, thereby increasing their ability to compete with the incumbent LEC.[1166] AT&T and MCI specifically argue that it would be technically feasible for them to interconnect their AIN SCP database to an incumbent LEC's AIN for the purpose of providing call processing instructions to the incumbent LEC's switch.[1167] Incumbent LECs contend that such interconnection would leave their switch vulnerable to a multitude of potential harms because sufficient mediation for such interconnection does not currently exist at the STP or SCP and has not yet been developed.[1168] AT&T counters that there is no need for additional mediation and that sufficient certification and testing of AIN based services before deployment in such a fashion is technically feasible.[1169]

502. At this time, in view of this record and the record compiled in the *Intelligent Networks* docket, we cannot make a determination of the technical feasibility of such interconnection. We do, however, believe that state commissions could find such an

[1164] 47 U.S.C. § 271(c)(2)(B)(x).

[1165] 47 U.S.C. § 153(29).

[1166] AT&T comments at 23-25; Cable & Wireless comments at 24; MCI comments at 18, 33.

[1167] AT&T comments at 23-25; MCI comments at 18, 33.

[1168] *See* U S West comments in CC Docket No. 91-346 at 73-74, 84; NYNEX comments in CC Docket No. 91-346 at 14-15; SBC comments in CC Docket No. 91-346 at 8-9.

[1169] *See AT&T Intelligent Networks Proposal* Attachment at 2.

arrangement to be technically feasible and we do not intend to preempt such an order through these rules. The Illinois Commission recently ordered access to incumbent LECs' AIN that does allow for this type of interconnection.[1170] We intend to address this issue early in 1997, either in the IN docket or in a subsequent phase of this proceeding, taking into account, *inter alia*, any relevant decisions of state commissions.[1171]

503. We also address the impact on small incumbent LECs. For example, GVNW asserts that any national rule requiring this form of interconnection would require many small incumbent LECs to make uneconomic upgrades of their switches in order to accommodate it.[1172] We have considered the economic impact of our rules in this section on small incumbent LECs. Accordingly, we have not adopted any national standards concerning AIN at this time. We also note that section 251(f) provides relief for certain small LECs from our regulations implementing section 251.

5. Operation Support Systems

a. Background

504. We sought comment, in the NPRM, on whether national requirements for electronic ordering interfaces would reduce the time and resources required for new entrants to enter and compete in regional markets.[1173] We also sought comment on the unbundling of databases generally in our discussion on unbundling database and signaling systems.[1174]

b. Comments

[1170] *Illinois Wholesale Order*.

[1171] There are other additional outstanding issues from the *Intelligent Networks* proceeding that are not resolved here including direct access to the SCP and national standards for AIN access.

[1172] GVNW comments at 30-31.

[1173] NPRM at para. 89.

[1174] NPRM at paras. 107-114.

505. Several new entrants argue that incumbent LECs should be required to unbundle access to their "operations support systems" and "back-office" databases as network elements.[1175] Parties define operations support systems and back office databases generally to include those systems and databases required for pre-ordering, ordering, provisioning, maintenance and repair, and billing.[1176] Several state commissions report that they have required incumbent LECs to provide access to some of these systems and databases.[1177] Potential competitors argue that, without such access, incumbent LECs can make it extremely difficult for them to utilize unbundled network elements and resold services, thereby severely impairing their ability to compete.[1178] Competitors argue that they should be able to access such incumbent LEC systems as necessary to receive and input data.[1179] Competitors contend that such access is required by sections 251(c)(3) and 251(c)(4) as part of the terms and conditions of each section.[1180] TCC further argues that until such access is in place,

[1175] ACTA comments at 14; ACSI comments at 42-43; ALTS comments at 31; American Network Exchange comments at 5; AT&T comments at 33-39; Cable & Wireless comments at 36-37; Citizens Utilities comments at 15; CompTel comments at 31; GCI comments at 16; MCI comments at 33; TCC comments at 54-60; Teleport comments at 38-39; Vartec comments at 6-10 (incumbent LECs should unbundle access to the Billing Name and Address database); WorldCom June 14 *Ex Parte at 4-5;* CompTel June 14 *Ex Parte*.

[1176] *See* Competition Policy Institute comments at 16; GCI comments at 16; MCI comments at 18; NCTA comments at 42; Sprint comments at 17-18, 41; Teleport comments at 38-39. MCI also identifies several "back office" databases it believes are necessary to provide competitive local telephone service including, among others, Customer Record Information System (CRIS), Master Street Address Guide (MSAG), CMDS System (industry mechanism to exchange billed messages such as third-party, collect and calling cards), Telecommunications Management Network Type Database (TMN), and Number Assignment Database. MCI July 3 *Ex Parte* at 2-4.

[1177] Texas Commission comments at 19 (number assignment, ordering and repairs); In Re Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms and Conditions and the Initial Unbundling of Services, Georgia Commission Docket 6352, (Georgia Commission May 29, 1996); Order Declaring Resale Prohibitions Void and Establishing Tariff Terms, New York Commission Case 94-C-0095 and Case 95-C-0657 (New York Commission June 25, 1996).

[1178] ACSI comments at 47; AT&T comments at 33-39 (an incumbent LEC's monopoly control over operational support systems is as formidable an obstacle to market entry as its control over the network itself); Cable & Wireless comments at 36-37; Citizens Utilities comments at 15; Continental comments at 19; Sprint comments at 17-19, 22; TCC comments at 54-60 (incumbent LECs can block new entry by refusing to install "automated, nondiscriminatory systems" for ordering, installing, maintaining, repairing and billing); Teleport comments at 38-39; CompTel comments at 37-38 (such access is necessary for competitors to combine unbundled network elements into telecommunications services of their own design); Vartec comments at 7-8 (competitors will be unable to compete unless incumbent LECs provide access to unbundled billing and collection functions).

[1179] *See, e.g.*, ACSI comments at 47; MCI comments at 24.

[1180] TCC comments at 56 (section 251(c)(3) requires that unbundled network elements be provided at nondiscriminatory rates, terms and conditions, and section (c)(4) requires that services for resale be provided free of any "unreasonable or discriminatory conditions or limitations"); CompTel comments at 37 (Commission should set an aggressive, firm deadline for compliance); GCI comments at 16.

incumbent LECs will not have met the requirements of either section 251(c)(3) or (c)(4) and therefore BOCs cannot be deemed to have met the requirements of section 271(c)(2)(B)(i).[1181]

506. In contrast, most incumbent LECs argue that operations support systems do not qualify as network elements under the 1996 Act.[1182] Ameritech argues that competitors have not demonstrated that they need access to such systems in order to provide telecommunications services.[1183] Several incumbent LECs assert that an incumbent LEC may negotiate with a competitor to provide such support services, but that the 1996 Act does not require them to unbundle these systems as network elements.[1184] Other parties argue that such access is not currently technically feasible and should be resolved through the negotiations process.[1185] SBC contends that its provisioning processes are neutral with respect to competing providers of service and that provisioning for competitors does not take longer than provisioning for its own customers.[1186]

507. Several potential local competitors, including most large IXCs, urge the Commission to require incumbent LECs to provide access to their operation support systems through real-time "electronic interfaces" or "electronic bonding."[1187] AT&T argues that virtually every incumbent LEC uses automated interfaces internally to support and coordinate

[1181] TCC comments at 56-57.

[1182] BellSouth comments at 45; GTE comments at 44; U S West comments at 48; Lincoln Tel. reply at 12-14; Ameritech reply at 19-20 (only for routing, terminating, billing or providing telecommunications service); Bell Atlantic reply at 12-23 n.15 (not necessary to offer service and numerous resellers have operated in Bell Atlantic territory without such direct access); BellSouth reply at 24, n.45; GTE reply at 23; NYNEX reply at 33-34; PacTel reply at 22 (operations support systems not used in the provision of a telecommunications service). Letter from Michael Glover, General Attorney, Bell Atlantic, to William Kennard, General Counsel, FCC, April 15, 1996 (Bell Atlantic April 15 *Ex Parte*).

[1183] Ameritech comments at 19-20; NYNEX comments at 33-34 (administrative databases are not used in routing or completion of calls); Bell Atlantic reply at 14; U S West reply at 27.

[1184] NYNEX comments at 33-34; Ameritech reply at 19-20; Lincoln Tel. reply at 14 (competitors must provide their own ordering systems); Bell Atlantic April 15 *Ex Parte* at 9.

[1185] Lincoln Tel. comments at 9 (re-engineering customer service systems only for purpose of supporting competitors would be extremely profligate); GVNW comments at 10-12.

[1186] Letter from Sandra Wagner, Director, Federal Regulatory, SBC Communications, Inc. to William Caton, Acting Secretary, FCC, June 4, 1996 (SBC June 4 *Ex Parte*).

[1187] ACTA comments at 14-15; AT&T comments at 33-39; MCI comments at 33-34; Sprint comments at viii, 17-19, 22; Teleport comments at 38-39; Texas Commission comments at 19; TCC comments at 56-58 Appendix D; AT&T reply at 20-21.

functionalities such as ordering, provisioning, maintenance, and billing.[1188] TCC argues that the availability of such operational interface standards for external interaction are limited, and that incumbent LECs have powerful disincentives to develop and implement such interfaces in the absence of clear rules requiring them.[1189] Parties commented that such interfaces are necessary so that carriers relying on interconnection, unbundled network elements, or resale from the incumbent LEC can offer their customers services of the same quality as those offered by the incumbent LEC.[1190] AT&T argues that incumbent LECs must provide such access for competitors at the same level of quality and within the same intervals as they do for their own end-users so that customers do not "perceive any differences in the quality of service provided by one carrier as compared to another."[1191] Competitors contend that such interfaces need to be similar to the PIC conversion process, so that it is as easy for consumers to switch local service providers as it is to switch interexchange carriers.[1192] Teleport argues that it would be at a competitive disadvantage if it was required to use slower, more expensive manual systems while the incumbent LEC continued to use its modern and efficient systems.[1193]

508. AT&T and TCC commented on AT&T's experience in the Rochester, New York market as a reseller of Rochester Telephone's services under Rochester Telephone's Open

[1188] AT&T comments at 36-37.

[1189] TCC comments at 55.

[1190] ACTA comments at 14-15; AT&T comments at 33-39; MCI comments at 33-34; Sprint comments at viii, 17-19, 22; Teleport comments at 38-39; TCC comments at 55 (a competitor must be able to seamlessly deliver services, add features, and bill "as if it owned the facilities").

[1191] AT&T comments at 35. AT&T argues that such a requirement is supported by Commission precedent including *Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Services by the Bell Operating Companies*, Report and Order, 95 F.C.C. 2d 1117, 1135-36 (1983) (adopting safeguards to prevent BOCs from providing superior access, installation, and maintenance services to themselves than to competitive providers of CPE, enhanced services and cellular services); *Amendment of Sections 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, Report and Order, 104 F.C.C. 2d 958, 1026-27 (1986) (requiring BOCs to provide competing enhanced service providers with comparably efficient interconnection "to control potential discrimination" by BOCs in favor of their own offerings); *id.* at 1041 (time periods for installation, maintenance, and repair must be the same for competing carriers as for BOC's own offerings).

[1192] ACTA comments at 16; AT&T comments at 35-36; CompTel comments at 3, 37; TCC comments at 54 (should be as easy for consumers to switch local service providers as it is currently to switch long distance providers). *See* Letter from Mary Brown, Director, Corporate Rates & Federal Regulatory Analysis, MCI, to William Kennard, General Counsel, FCC, Mar. 20, 1996 (*IXCs Joint Ex Parte*) at 6.

[1193] Teleport comments at 39; *accord* TCC comments at 55 (for example, an incumbent LEC could enter its own service orders electronically, but require the competing carrier to submit such orders manually via a multiple page form faxed or e-mailed to the incumbent for subsequent processing).

Market Plan.[1194] Parties noted that AT&T was required to submit a detailed order form, initially through a facsimile machine and later through e-mail, in order to resell Rochester Telephone services.[1195] AT&T asserts that it was signing up between one and two hundred new customers daily and therefore had to fax up to 1400 pages daily to Rochester Telephone.[1196] AT&T and TCC contend that such a manual process is clearly discriminatory and in violation of the 1996 Act because it creates additional delay and the potential for human error, resulting in customer dissatisfaction.[1197] TCC argues further that such a disparity in systems allows for the incumbent LEC to schedule service commencement and issue new phone numbers during the initial contact with a customer, while the competitor, at best, must put the customer on hold while it calls the incumbent LEC to obtain such information.[1198]

509. Several parties argue that electronic interfaces should provide competitors with transparent access to the underlying information rather than the individual databases necessary for ordering and provisioning, installation, maintenance and repair, recording and billing, and monitoring service.[1199] Commenters assert that large incumbent LECs may have, for example, certain information necessary for billing, stored among several databases systems, each with individual operating systems.[1200] AT&T asserts that it will be difficult and expensive for a

[1194] *See* Petition of Rochester Telephone Corp. for Approval of Proposed Restructuring Plan, Opinion and Order Approving Joint Stipulation and Agreement, Case 93-C-0103, Opinion No. 94-25 (NY Pub. Serv. Comm'n) (Nov.10, 1994); *In the Matter of Rochester Telephone Corp., Petition for Waivers to Implement its Open Market Plan*, 10 FCC Rcd 6776 (1995); *see also* Big Boys Come Calling, N.Y. Times, Oct. 19, 1995 at 1.

[1195] AT&T comments at 34-35 (AT&T had to complete a multi-page form for every individual customer that wanted to switch to AT&T and Rochester Telephone would not change a customer's service until AT&T faxed multiple documents to it); TCC comments at 55.

[1196] AT&T comments at 34 (AT&T estimated that for each customer it ordered services for, it took at least four hours for Rochester to complete and respond to AT&T).

[1197] AT&T comments at 34 (AT&T argues that the problems with a manual process were "intolerable" in the Rochester market, and would be significantly magnified in larger or more heavily populated areas); TCC comments at 55.

[1198] TCC comments at 55-56 (at worst the competing carrier must hang up with the customer and call back later with the necessary information).

[1199] AT&T comments at 33-39; Telecommunications Resellers Ass'n comments at 22 n.52-53; TCC comments at 56 -57 (electronic interface capabilities should allow competitors, *inter alia*, to enter customer trouble reports, obtain report commitments, schedule customer site visits and receive notification of network conditions affecting service); Letter from Antoinette Cook Bush, Counsel, Ameritech to William Caton, Acting Secretary, FCC, July 10, 1996 (Ameritech July 10 *Ex Parte*). Ameritech argues that, once operational interfaces are in place, it will be unnecessary for carriers to provide competitors with direct access to the underlying systems or databases providing such functions. *Id.* at 5.

[1200] AT&T comments at 33-39.

competing carrier to individually access multiple systems and that the difficulty and expense will be compounded for parties wishing to compete in several incumbent LECs' territories.[1201] AT&T contends, therefore, that incumbent LECs should create and deploy a "gateway" to all of their internal operations support systems and databases so that a competing carrier could use one method of access to the underlying information.[1202] U S West contends that competitors must develop systems that are compatible with incumbent LEC electronic interfaces and argues that incumbent LECs should not be required to develop individualized systems for each competing carrier.[1203]

510. Since the passage of the 1996 Act, several states have proceeded to implement rules for local competition, several of which include provisions concerning electronic interfaces.[1204] The Georgia Commission ordered BellSouth to establish electronic operational interfaces by July 15, 1996, and ordered both incumbent BellSouth and requesting carrier AT&T to submit a joint report to the commission within thirty days concerning the implementation schedule necessary to deploy such interfaces.[1205] After a motion for reconsideration, the Georgia Commission provided BellSouth with an additional month to establish these interfaces and added additional deadlines for the deployment and operation of such interfaces.[1206] The Illinois Commission ordered Ameritech and Centel to provide competitors with "all operational interfaces at parity with those provided their own retail

[1201] *Id.*

[1202] *Id.*

[1203] Letter from Cyndie Eby, Executive Director -- Federal Regulatory, U S West to Robert Tanner, Attorney Advisor, FCC, July 9, 1996 (U S West July 9 *Ex Parte*).

[1204] Letter from Bruce Cox, Government Affairs Director, AT&T to William Caton, Acting Secretary, FCC, July 11, 1996 (AT&T July 11 *Ex Parte*). AT&T submitted orders or rules from eight states that have taken action on the issue of electronic interfaces. *Id.*

[1205] Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms and Conditions and the Initial Unbundling of Services, Docket No. 6352-U at 11-12, 15 (Georgia Commission May 29, 1996). The Georgia Commission ordered BellSouth to establish interfaces for "pre-service ordering, service ordering and provisioning, directory listing and line information databases, service trouble reporting, and daily usage data." *Id.* at 15.

[1206] Motion for Reconsideration in Docket No. 6352-U (Georgia Commission July 2, 1996). The Georgia Commission directed that most electronic interfaces must be fully operational by the end of 1996, and established March 31, 1997 as an absolute deadline. *Id.*

customers."[1207] The Louisiana Commission has proposed rules on local competition that require incumbent LECs to deploy systems for competitors that are equivalent to those used by incumbents for their own retail exchange services.[1208] Under those rules, such access must be equal to that provided to an incumbent LECs' own personnel.[1209] The California Commission adopted interim rules ordering incumbent LECs to deploy automated on-line systems for access by competitors.[1210] The Indiana Commission concluded that a competitor's ability to utilize "electronic access, technical interfaces, or access to databases to place service orders, receive phone number assignments, receive information necessary to bill [its] customers and to inform the incumbent LEC of cases of trouble" is essential to the development of resale competition.[1211] Indiana ordered incumbent LECs to provide all operational interfaces at parity with those the incumbent provides to its own retail customers.[1212] The Ohio Commission's rules on local competition require all LECs to provide "nondiscriminatory, automated operational support systems" that support access by competing carriers to such functions as pre-ordering, ordering, provisioning, repair and maintenance, number assignment, and billing.[1213] The Oklahoma Commission has proposed rules that require an incumbent LEC, to the extent it provides itself, its affiliates or subsidiaries,

[1207] *Illinois Wholesale Order*. The Illinois Commission ordered both incumbent LECs, to the extent they could not "fully and immediately" implement operational parity, to submit a plan with specific timetables for achieving compliance. *Id.* at 51.

[1208] Substitute Proposed Regulations for Competition in the Local Telecommunications Market, Docket No. U-20883 (Louisiana Commission March 5, 1996). The Louisiana Commission further requires "direct on-line access" to incumbent LECs' mechanized order entry system, number administration system, trouble reporting and monitoring system, customer usage data, and local listing databases. *Id.*

[1209] *Id.*

[1210] Order Instituting Rulemaking on the Commission's Own Motion into Competition for Local Exchange Service, R. 95-04-043 and I. 95-04-044 (California Commission April 26, 1995). The California Commission ordered such access for "service ordering and implementation scheduling." *Id.* at Appendix E, 14.

[1211] In the Matter of the Investigation on the Commission's Own Motion into Any and All Matters Relating to Local Telephone Exchange Competition Within the State of Indiana, Cause No. 39983, Interim Order on Bundled Resale and Other Issues (Indiana Commission July 1, 1996).

[1212] *Id.* at 49. The Commission also ordered incumbents Ameritech and GTE, to the extent they contend that they are unable to fully and immediately implement operational parity, to submit a comprehensive plan with specific timetables for achieving compliance. *Id.*

[1213] In the Matter of the Commission Investigation Relative to the Establishment of Local Exchange Competition and Other Competitive Issues, Case No. 95-845-TP-COI (Ohio Commission June 12, 1996).

automated interfaces for the purpose of service ordering, maintenance or repair, to make such interfaces available to competitors.[1214]

511. A few incumbent LECs commented on their own efforts to develop and implement electronic interfaces, including development of a single gateway for competing carrier access. Ameritech contends that "operational interfaces are essential to promote viable competitive entry."[1215] Bell Atlantic states that it currently provides ordering and repair information to IXCs and is working on implementing similar electronic interfaces for competing local carriers.[1216] GTE commented that it supports access to its trouble administration information for AT&T and MCI.[1217] U S West also supports trouble administration electronic access for AT&T and MCI and is developing access to all of its operations support systems for IXCs.[1218] U S West also states that it expects to build on such access for IXCs to develop access to meet the needs of local competitors.[1219] NYNEX also provides currently for electronic access for IXCs to its operations support systems for presubscription, ordering and provisioning, trouble administration, and access billing.[1220] NYNEX, which has been ordered by the New York Commission to provide electronic

[1214] All Sources Proposed Rules,Docket No. RM950000019 (Local Telephone Competition) (Oklahoma Commission March 7, 1996). Oklahoma rules clarify that such interfaces should not permit competitors to directly access the incumbent's underlying systems. *Id.* at 79.

[1215] Ameritech July 10 *Ex Parte*.

[1216] Letter from Patricia Koch, Assistant Vice President, Federal External Affairs and Regulatory Relations, Bell Atlantic, to William Caton, Acting Secretary, FCC, June 21, 1996 (Bell Atlantic June 21 *Ex Parte*).

[1217] GTE reply at 23 n.31 (GTE provides electronic bonding for trouble administration to both AT&T and MCI).

[1218] Letter from Cyndie Eby, Executive Director-Federal Regulatory to William Caton, Acting Secretary, FCC, June 28, 1996 (U S West June 28 *Ex Parte*). U S West supports a mediated electronic interface for IXCs to submit trouble reports to U S West. *Id.*

[1219] U S West July 9 *Ex Parte*.

[1220] Letter from Alan Cort, Director, Federal Regulatory Matters, NYNEX to William Caton, Acting Secretary, FCC, July 12, 1996 (NYNEX July 12 *Ex Parte*). Such electronic access can be achieved through "a stand alone PC with a dial up modem, or through a customer's [IXC's] network to allow network to network connectivity." *Id.*

interfaces for local competitors by October 1, 1996,[1221] recently proposed to expand the use of its current electronic access for IXCs to local competitors.[1222]

512. Sprint and MCI argue that current use of electronic interfaces, including the Customer Account Record Exchange (CARE) system used by LECs and IXCs to exchange subscriber account information electronically, is evidence of the technical feasibility of electronic bonding.[1223] TCC urges the Commission to require the provision of timely and accurate CARE by all local service providers to all IXCs.[1224] Vartec asserts that incumbent LECs and IXCs already share access to the Billing Name and Address (BNA) database.[1225] TCC argues that all local service providers should be required to continue to support the standard interface that exists today for IXCs to request BNA information to complete the billing process for its customers.[1226] In addition, TCC notes that competing carriers purchasing unbundled local switching from the incumbent LEC will require access to billing data to bill IXCs for exchange access.[1227]

513. Several commenters advocate national standards for electronic interfaces.[1228] Ameritech asserts that "[t]he ability to do business between multiple local exchange carriers and incumbent LECs dictates that these electronic interfaces adhere to national or industry-based standards where available."[1229] Sprint proposes that the Commission require industry to

[1221] Order Declaring Resale Prohibitions Void and Establishing Tariff Terms, Case 94-C-0095, *et. al*, (New York Commission June 25, 1996).

[1222] Letter from Alan Cort, Director, Federal Regulatory Matters, NYNEX to William Caton, Acting Secretary, FCC July 17, 1996 (NYNEX July 17 *Ex Parte*). NYNEX will provide competing providers with access to its Direct Customer Access System. It is currently testing local service applications with potential new entrants. *Id.*

[1223] MCI comments at 18; Sprint comments at 17; TCC comments at 58 n.60 (currently there are approximately 56 million CARE transactions annually).

[1224] TCC comments at 58 (CARE information includes a customer's billing telephone number, working telephone number, billing address and service address).

[1225] Vartec comments at 8-9.

[1226] TCC comments at 58-59.

[1227] TCC comments at 59.

[1228] AT&T comments at 36-39; Cable & Wireless comments at 36-37; Teleport comments at 38-39.

[1229] Ameritech July 10 *Ex Parte* at 5.

develop such standards and incumbent LECs to implement those standards within twelve months.[1230] AT&T argues that, while industry has primary responsibility for developing standards, section 256(b)(1) establishes an "oversight" responsibility for the Commission in the development of such industry standards.[1231] American Communications Services argues that such standards should conform to Bellcore and ANSI requirements as well as relevant industry guidelines and manufacturer specifications.[1232] Ameritech asserts that, if an ANSI or other national or industry-based standard exists, incumbent LECs should have a duty to conform their electronic interfaces to those standards within a reasonable period of time.[1233] Sprint reports that industry has been working on developing standards for electronic interfaces in the Electronic Communications Implementation Committee (ECIC),[1234] a working committee in the Telecommunications Industry Forum of the Alliance for Telecommunications Industry Solutions (ATIS).[1235] The ECIC defines electronic bonding as "interactive electronic information exchange involving application-to-application communications between telecommunications jurisdictions" supporting operations, administration, maintenance, and provisioning.[1236] The ECIC has already developed guidelines for a "Trouble Administration" application and is close to completing those for an "Interexchange Carrier/Customer Account

[1230] Sprint comments at 18. *See also* AT&T comments at 38. AT&T urges the Commission to direct industry to work towards developing such standards, set a date for their implementation and make it clear to incumbent LECs that such standards are a necessary part of meeting the requirements of sections 251(c)(3) and (c)(4). *Id.*

[1231] AT&T comments at 38.

[1232] ACSI comments at 47; *see* Ameritech July 10 *Ex Parte* at 5. Ameritech adds that the telecommunications industry has the responsibility to develop its own standards through existing bodies such as ANSI. *Id.*

[1233] Ameritech July 10 *Ex Parte* at 5.

[1234] ECIC was formerly known as the Electronic Bonding Implementation Team (EBIT) before becoming a working committee of ATIS.

[1235] Letter from Jay Keithley, Vice President, Law & External Affairs, Sprint , to William F. Caton, Acting Secretary, FCC, June 25, 1996 (Sprint June 25 *Ex Parte*). Current active members of the ECIC include: Ameritech, AT&T, Bell Atlantic, BellSouth, Cincinnati Bell, DSET, GTE, MCI, NYNEX, Objective Systems Integrators, OpenCon Systems, Pacific Bell, Pirelli Cable, SNET, Southwestern Bell, Sprint, Touch of Gray Engineering, Telegenics, Teleport, and U S West. *Id. See also* Letter from Todd Silbergeld, Director--Federal Regulatory, SBC Communications to William Caton, Acting Secretary, FCC (July 12, 1996) (SBC July 12 *Ex Parte*).

[1236] Sprint June 25 *Ex Parte*.

Record Exchange" application.[1237] A few incumbent LECs identified the "Electronic Data Interchange (EDI)" standard as a potential basis for electronic interfaces.[1238] Several parties also commented that the Ordering and Billing Forum (OBF) is working on developing standards for electronic interfaces.[1239] SBC and NYNEX note that ECIC, OBF, EDI and the T1M1 standards committees[1240] are all working in conjunction to develop electronic interfaces for inter-telecommunications company transactions.[1241]

514. AT&T argues that a national standard for electronic interfaces should provide for a uniform method of access to underlying information by competing carriers to all incumbent LECs. As envisioned by AT&T, such a gateway would provide transparent access for all competing local exchange providers to incumbent LEC administrative and back office databases. Bell Atlantic and AT&T together agree that, given "appropriate guidance from the Commission, the industry can achieve consensus on sufficient data elements and formatting conventions to facilitate that 95% of all inter-telecommunications company transactions may be processed via electronic gateways within twelve months."[1242] Bell Atlantic and AT&T argue that "transaction sets"[1243] to facilitate the exchange of information across electronic

[1237] Sprint June 25 *Ex Parte*. The ECIC will next work on a "Ordering/Provisioning" application. It has identified but not yet established priorities for other applications including: Performance Monitoring, Alarm Monitoring, Network Management, Traffic Management, Testing and Reporting, Ordering Competitive LEC Services (including Resale), Ordering SONET, Product Availability/Capability, Electronic Bonding for Government and Large Customers, and Intercompany Billing. *Id. See also* U S West July 9 *Ex Parte*.

[1238] Ameritech July 10 *Ex Parte* at 5-6. EDI is defined by the Telecommunications Industry Forum. *Id. at 6.*

[1239] AT&T comments at 38; BellSouth reply at 27; Ameritech July 10 *Ex Parte* at 5. An electronic ordering interface could be based on the "access service request" defined by OBF. Billing information could be exchanged via the "exchange message interface" or the "exchange message record" also defined by OBF. Ameritech July 10 *Ex Parte* at 5-6.

[1240] T1M1 is a standards committee under the T1 Telecommunications committee, and is a part of ATIS.

[1241] SBC July 12 *Ex Parte*; NYNEX July 17 *Ex Parte*.

[1242] Letter from Bruce Cox, Government Affairs Director to William Caton, Acting Secretary, FCC, July 3, 1996 (*AT&T-Bell Atlantic Joint Ex Parte*). This language was also supported by Beechwood Data Systems, a systems integrator company working with, among others, AT&T and NYNEX on electronic interfaces.

[1243] A "transaction set" refers to a set of standard data elements necessary to support any electronic exchange of information for a particular function, like provisioning.

interfaces need to be created to support the functions of pre-ordering and ordering,[1244] provisioning,[1245] repair and maintenance,[1246] and billing.[1247] AT&T commented that electronic interfaces are scalable to different size entities, so that any phone company with at least a PC computer and a modem can utilize one of their applications.[1248]

515. Several state commissions commented that they are not opposed to national standards but want the flexibility to implement additional or different state standards.[1249] The Colorado Commission believes national technical standards are a worthy goal, but they must carefully consider differences in regional and network conditions.[1250] The California Commission, however, contends that incumbent LEC provisioning systems vary considerably by company and region.[1251] Incumbent LECs argue that there should be no national standards for the provision, maintenance and repair of network elements because operating and administrative systems differ between incumbent LECs.[1252]

[1244] Pre-ordering and ordering includes the exchange of information between LECs about current or proposed customer products and services or unbundled network elements or some combination thereof. *AT&T-Bell Atlantic Joint Ex Parte*. TCC includes such information as customer data on current services, and credit and payment history. TCC comments at 57 n.58, Appendix D.

[1245] Provisioning involves the exchange of information between LECs where one executes a request for a set of products and services or unbundled network elements or combination thereof from the other with attendant acknowledgements and status reports. *AT&T-Bell Atlantic Joint Ex Parte.*

[1246] Maintenance [and repair] involves the exchange of information between LECs where one initiates a request for repair of existing products and services or unbundled network elements or combination thereof from the other with attendant acknowledgements and status reports. *AT&T-Bell Atlantic Joint Ex Parte.*

[1247] Billing involves the provision of appropriate usage data by one LEC to another to facilitate customer billing with attendant acknowledgements and status reports. It also involves the exchange of information between LECs to process claims and adjustments. *AT&T-Bell Atlantic Joint Ex Parte.*

[1248] Letter from Bruce Cox, Government Affairs Director, AT&T to William Caton, Acting Secretary, FCC, July 1, 1996 (AT&T July 1 *Ex Parte*).

[1249] Pennsylvania Commission comments at 25; *but see* California Commission comments at 26-28 (standards could hinder innovation and efficiency).

[1250] Colorado Commission comments at 24-25, 27.

[1251] California Commission comments at 27 (the two biggest incumbent LECs in California have significant differences in how they provision and operate their network).

[252] Bell Atlantic comments at 31; PacTel comments at 40-44 (Commission could order standards for similarly situated networks but there will be many differences between incumbent LECs' ordering and billing systems); NYNEX reply comments at 32-33 (arguing that there are also differences in incumbent LECs' test equipment).

c. Discussion

516. We conclude that operations support systems and the information they contain fall squarely within the definition of "network element" and must be unbundled upon request under section 251(c)(3), as discussed below. Congress included in the definition of "network element" the terms "databases" and "information sufficient for billing and collection or used in the transmission, routing, *or other provision* of a telecommunications service."[1253] We believe that the inclusion of these terms in the definition of "network element" is a recognition that the massive operations support systems employed by incumbent LECs, and the information such systems maintain and update to administer telecommunications networks and services, represent a significant potential barrier to entry. It is these systems that determine, in large part, the speed and efficiency with which incumbent LECs can market, order, provision, and maintain telecommunications services and facilities. Thus, we agree with Ameritech that "[o]perational interfaces are essential to promote viable competitive entry."[1254]

517. Nondiscriminatory access to operations support systems functions can be viewed in at least three ways. First, operations support systems themselves can be characterized as "databases" or "facilit[ies] . . . used in the provision of a telecommunications service," and the functions performed by such systems can be characterized as "features, functions, and capabilities that are provided by means of such facilit[ies]."[1255] Second, the information contained in, and processed by operations support systems can be classified as "information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service."[1256] Third, nondiscriminatory access to the functions of operations support systems, which would include access to the information they contain, could be viewed as a "term or condition" of unbundling other network elements under section 251(c)(3), or resale under section 251(c)(4). Thus, we conclude that, under any of these interpretations, operations support systems functions are subject to the nondiscriminatory access duty imposed by section 251(c)(3), and the duty imposed by section 251(c)(4) to provide resale services under just, reasonable, and nondiscriminatory terms and conditions.

518. Much of the information maintained by these systems is critical to the ability of other carriers to compete with incumbent LECs using unbundled network elements or resold services. Without access to review, *inter alia*, available telephone numbers, service interval

---

[1253] 47 U.S.C. § 153(29) (emphasis added).

[1254] Ameritech July 10 *Ex Parte* at 5.

[1255] 47 U.S.C. § 153(29).

[1256] *Id.*

information, and maintenance histories, competing carriers would operate at a significant disadvantage with respect to the incumbent. Other information, such as the facilities and services assigned to a particular customer, is necessary to a competing carrier's ability to provision and offer competing services to incumbent LEC customers.[1257] Finally, if competing carriers are unable to perform the functions of pre-ordering, ordering, provisioning, maintenance and repair, and billing for network elements and resale services in substantially the same time and manner that an incumbent can for itself, competing carriers will be severely disadvantaged, if not precluded altogether, from fairly competing. Thus providing nondiscriminatory access to these support systems functions, which would include access to the information such systems contain, is vital to creating opportunities for meaningful competition.

519. As noted in the comments above, several state commissions have ordered real-time access or have ongoing proceedings working to develop and implement it within their jurisdictions. The New York Commission, building on its pioneering experience with the Rochester Telephone "Open Market Plan," has facilitated a working group on electronic interfaces comprised of both incumbent LECs and potential competitors.[1258] The New York Commission focused on these issues in response to the frustrations and concerns of resellers in the Rochester market.[1259] In particular, AT&T alleged that it was "severely disadvantaged due to the fact that [Rochester Telephone] has failed to provide procedures for resellers to access [their] databases for on-line queries needed to perform basic service functions [such] as scheduling customer appointments."[1260] The New York Commission has concluded that wherever possible NYNEX will provide new entrants with real-time electronic access to its systems.[1261] As another example, the Georgia Commission recently ordered BellSouth to provide electronic interfaces such that resellers have the same access to operations support systems and informational databases as BellSouth does, including interfaces for pre-ordering,

---

[1257] For these reasons, it is most important that incumbent LECs, which currently own the overwhelming majority of local facilities in any market provide this information to those new entrants who initially will rely to varying degrees on incumbent LEC facilities. *See e.g.*, AT&T comments at 33-34.

[1258] Order Declaring Resale Prohibitions Void and Establishing Tariff Terms, Case 94-C-0095, *et. al.* (New York Commission June 25, 1996).

[1259] Order Declaring Resale Prohibitions Void and Establishing Tariff Terms, Case 94-C-0095, *et. al.* (New York Commission June 25, 1996). In New York proceeding, resellers argued that interfaces were as important to competition as the level of the wholesale discount. *Id.*

[1260] AT&T Communications of New York, Inc. Complaint, Petition for Declaratory Judgement and for Reconsideration of Opinion No. 94-25 New York Commission, page 12.

[1261] *Id.* at 13-14. The New York Commission operations working group has focused on five areas for implementation: (1) service ordering, (2) trouble administration, (3) credit and collection, (4) billing and usage detail, (5) local exchange company requirements. *Id.* at 13-17.

ordering and provisioning, service trouble reporting, and customer daily usage.[1262] In testimony before the Georgia Commission, a BellSouth witness acknowledged that "[n]o one is happy, believe me, with a system that is not fully electronic."[1263] As noted above, Georgia ordered BellSouth to establish these interfaces within two months of its order (by July 15, 1996), but recently extended the deadline an additional month (to August 15th).[1264] Both the Illinois and Indiana Commissions ordered incumbent LECs immediately to provide to competitors access to operational interfaces at parity with those provided to their own retail customers, or submit plans with specific timetables for achieving such access.[1265] Several other states have passed laws or adopted rules ordering incumbent LECs to provide interfaces for access equal to that the incumbent provides itself.[1266] We recognize the lead taken by these states and others, and we generally rely upon their conclusions in this Order.

520. We conclude that providing nondiscriminatory access to operations support systems functions is technically feasible. Incumbent LECs today provide IXCs with different types of electronic ordering or trouble interfaces that demonstrate the feasibility of such access, and perhaps also provide a basis for adapting such interfaces for use between local service providers.[1267] Further, as discussed above, several incumbent LECs, including NYNEX and Bell Atlantic, are already testing and operating interfaces that support limited functions, and are developing the interfaces to support access to the remaining functions identified by most potential competitors.[1268] Some incumbent LECs acknowledge that

[1262] *See* In Re Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms and Conditions and the Initial Unbundling of Services, Docket 6352, (Georgia Commission May 29, 1996).

[1263] *Id.*

[1264] Motion for Reconsideration in Docket No. 6352-U (Georgia Commission July 2, 1996).

[1265] In the Matter of the Investigation on the Commission's Own Motion into Any and All Matters Relating to Local Telephone Exchange Competition Within the State of Indiana, Cause No. 39983, Interim Order on Bundled Resale and Other Issues (Indiana Commissions July 1, 1996); *Illinois Wholesale Order.*

[1266] *See e.g.*, Texas Commission comments at 19; In the Matter of the Commission Investigation Relative to the Establishment of Local Exchange Competition and Other Competitive Issues, Case No. 95-845-TP-COI (Ohio Commission June 12, 1996); Order Instituting Rulemaking on the Commission's Own Motion into Competition for Local Exchange Service, R. 95-04-043 and I. 95-04-044 (California Commission April 26, 1995).

[1267] *See, e.g.*, Bell Atlantic June 21 *Ex Parte*; NYNEX July 12 *Ex Parte*; NYNEX July 17 *Ex Parte*; U S West June 28 *Ex Parte*; U S West July 9 *Ex Parte.*

[1268] Bell Atlantic June 21 *Ex Parte*; NYNEX July 17 *Ex Parte.*

nondiscriminatory access to operations support systems functions is technically feasible.[1269] Finally, several industry groups are actively establishing standards for inter-telecommunications company transactions.[1270]

521. Section 251(d)(2)(A) requires the Commission to consider whether "access to such network elements as are proprietary in nature is necessary."[1271] Incumbent LECs argue that there are proprietary interfaces used to access these databases and information. Parties seeking to compete with incumbent LECs counter that access to such databases and information is vitally important to the ability to broadly compete with the incumbent. As discussed above, competitors also argue that such access is necessary to order, provision, and maintain unbundled network elements and resold services, and to market competing services effectively to an incumbent LEC's customers. We find that it is absolutely necessary for competitive carriers to have access to operations support systems functions in order to successfully enter the local service market.

522. Section 251(d)(2)(B) requires the Commission to consider whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[1272] As mentioned above, parties identified access to operations support systems functions as critical to the provision of local service. We find that such operations support systems functions are essential to the ability of competitors to provide services in a fully competitive local service market. Therefore, we conclude that competitors' ability to provide service successfully would be significantly impaired if they did not have access to incumbent LECs' operations support systems functions.

523. We thus conclude that an incumbent LEC must provide nondiscriminatory access to their operations support systems functions for pre-ordering, ordering, provisioning, maintenance and repair, and billing available to the LEC itself.[1273] Such nondiscriminatory

[1269] *See* NYNEX reply at 33-34; GTE reply at 23 n.28; Bell Atlantic reply at 14.

[1270] Industry standards committees include ECIC, EDI, OBF and T1M1. *See* Ameritech July 10 *Ex Parte*, Sprint June 25 *Ex Parte*, NYNEX July 17 *Ex Parte.*

[1271] 47 U.S.C. § 251(d)(2)(A).

[1272] 47 U.S.C. § 251(d)(2)(B).

[1273] We adopt the definition of these terms as set forth in the *AT&T-Bell Atlantic Joint Ex Parte* as the minimum necessary for our requirements. We note, however, that individual incumbent LEC's operations support systems may not clearly mirror these definitions. Nevertheless, incumbent LECs must provide nondiscriminatory access to the full range of functions within pre-ordering, ordering, provisioning, maintenance and repair and billing enjoyed by the incumbent LEC.

access necessarily includes access to the functionality of any internal gateway systems[1274] the incumbent employs in performing the above functions for its own customers. For example, to the extent that customer service representatives of the incumbent have access to available telephone numbers or service interval information during customer contacts, the incumbent must provide the same access to competing providers. Obviously, an incumbent that provisions network resources electronically does not discharge its obligation under section 251(c)(3) by offering competing providers access that involves human intervention, such as facsimile-based ordering.[1275]

524. We recognize that, although technically feasible, providing nondiscriminatory access to operations support systems functions may require some modifications to existing systems necessary to accommodate such access by competing providers.[1276] Although, as discussed above, many incumbent LECs are actively developing these systems, even the largest and most advanced incumbent LECs have not completed interfaces that provide such access to all of their support systems functions. State commissions such as Georgia, Illinois, and Indiana, however, have ordered that such access be made available to requesting carriers in the near term. As a practical matter, the interfaces developed by incumbents to accommodate nondiscriminatory access will likely provide such access for services and elements beyond a particular state's boundaries, and thus we believe that requirements for such access by a small number of states representing a cross-section of the country will quickly lead to incumbents providing access in all regions.

525. In all cases, however, we conclude that in order to comply fully with section 251(c)(3) an incumbent LEC must provide, upon request, nondiscriminatory access to operations support systems functions for pre-ordering, ordering, provisioning, maintenance and repair, and billing of unbundled network elements under section 251(c)(3) and resold services under section 251(c)(4). Incumbent LECs that currently do not comply with this requirement of section 251(c)(3) must do so as expeditiously as possible, but in any event no later than January 1, 1997.[1277] We believe that the record demonstrates that incumbent LECs and several national standards-setting organizations have made significant progress in developing

[1274] A gateway system refers to any electronic interface the incumbent LEC has created for its own use in accessing support systems for providing pre-ordering, ordering, provisioning, repair and maintenance, and billing.

[1275] Such access was all that Rochester Telephone provided to AT&T, when AT&T attempted to compete as a reseller of Rochester Telephone service. *See* Letter from Bruce Cox, Government Affairs Director, AT&T to William Caton, Acting Secretary, FCC, July 10, 1996 (AT&T July 10 *Ex Parte*).

[1276] *See supra*, Section V.G. regarding accommodation of unbundling.

[1277] *See infra*, Section VII.B. for a discussion of exemptions and suspensions for small and rural incumbent LECs.

such access. This progress is also reflected in a number of states requiring competitor access to these transactional functions in the near term. Thus, we believe that it is reasonable to expect that by January 1, 1997, new entrants will be able to compete for end user customers by obtaining nondiscriminatory access to operations support systems functions.

526. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, RTC urges us to recognize the differences between carriers in regards to computerized network administration and operational interfaces. Our requirement of nondiscriminatory access to operations support systems recognizes that different incumbent LECs possess different existing systems. We also note, however, that section 251(f) of the 1996 Act provides relief for certain small LECs from our regulations implementing section 251.

527. Ideally, each incumbent LEC would provide access to support systems through a nationally standardized gateway. Such national standards would eliminate the need for new entrants to develop multiple interface systems, one for each incumbent. We believe that the progress made by standards-setting organizations to date evidences a strong national movement toward such a uniform standard.[1278] For example, both AT&T and Bell Atlantic agree that, given appropriate guidance from the Commission, the industry can achieve consensus on national standards such that within 12 months 95% of all inter-telecommunications company transactions may be processed via nationally standardized electronic gateways.[1279]

528. In order to ensure continued progress in establishing national standards, we propose to monitor closely the progress of industry organizations as they implement the rules adopted in this proceeding. Depending upon the progress made, we will make a determination in the near future as to whether our obligations under the 1996 Act require us to issue a separate notice of proposed rulemaking or take other action to guide industry efforts at arriving at appropriate national standards for access to operations support systems.

6. Other Network Elements

a. Background

529. In the NPRM, we requested comment on other network elements the Commission should require incumbent LECs to unbundle. We tentatively concluded that

[1278] *See* Sprint June 25 *Ex Parte*; AT&T comments at 38; BellSouth reply at 27.

[1279] *AT&T-Bell Atlantic Joint Ex Parte*.

"subscriber numbers" and "operator call completion services" should be unbundled.[1280] We also, under our discussion of section 251(b)(3), sought comment on nondiscriminatory access to telephone numbers, operator services, and directory assistance.[1281]

b. Comments

530. Many parties support the Commission's tentative conclusion that incumbent LECs should be required to unbundle "operator call completion services" as a separate network element.[1282] AT&T argues that such a network element would be more correctly described as the "operator systems" used to provide these services.[1283] Some state commissions have proposed or required unbundling of operator services because they are critical to new entrants' ability to enter the local exchange market.[1284] Several incumbent LECs, however, argue that they should not be required to unbundle operator services as a network element, because both alternative providers and incumbent LECs provide them on a nondiscriminatory basis.[1285] Some incumbent LECs also advance the argument that Congress did not intend for operator services to be treated as a network element, instead requiring

[1280] NPRM at para. 116.

[1281] NPRM at paras. 214-217.

[1282] ACSI comments at 44; ALTS comments at 32 (competitors must have nondiscriminatory access to busy line verification and call interrupt as these functionalities are currently only available from the incumbent LEC); AT&T comments at 26; Continental comments at 19; MCI comments at 18-20; Cable & Wireless comments at 20; Citizens Utilities comments at 15; Colorado Commission comments at 24; Comcast comments at 20; Competition Policy Institute comments at 16; DOJ comments at 21; Frontier comments at 17 n.32; GCI comments at 12; Telecommunications Resellers Ass'n comments at 36; TIA comments at 13 (special toll, public telephone and other calls requiring operator assistance); Wyoming Commission comments at 21; Jones Intercable reply at 30.

[1283] AT&T comments at 26 n.32; *see also* Competition Policy Institute comments at 16 (defined operator services as the live or mechanized systems which provide customers with operator services, such as call intercept, directory assistance and call completion); Jones Intercable reply at 30 n.51.

[1284] Wyoming comments at 22; *Illinois Wholesale Order*; AT&T reply 20-21 n.34. *See* Letter from Daniel Brenner, Vice President for Law & Regulatory Policy, NCTA, to Regina Keeney, Chief, Common Carrier Bureau, FCC, April 15, 1996 (NCTA April 15 *Ex Parte*).

[1285] Bell Atlantic comments at 30 (operator services is a competitive market with over 145 operator services providers in the United States); GTE comments at 44; USTA comments at 17 (incumbent LECs already provide operator services on a contract or tariff basis); U S West comments at 46 n.103.

BOCs to provide nondiscriminatory access to such services as one of the conditions for BOC entry into in-region interLATA services under section 271.[1286]

531. Commenters advance different proposals as to how to unbundle access to operator call completion services. Some competitors advocate defining the entire service as a network element so that a competitor could provide its own operator services by interconnecting at the incumbent LEC's switch.[1287] AT&T argues that such services are not necessary for competitors that have their own comparable systems.[1288] Some competitors argue that incumbent LECs must make subscriber name and number and billing and collection services available so that a competitor can provide call completion and directory assistance with its own operators.[1289] Other parties, mostly incumbent LECs, state that such a proposal is not technically feasible.[1290] MCI further states that it needs access to incumbent LEC subscriber number information for the provision of directory assistance and call completion services by its own operator systems.[1291] Other competitors want the incumbent LEC to provide them with unbranded operator call completion services,[1292] much as some of the larger incumbent LECs and IXCs do now for smaller carriers.[1293]

[1286] Ameritech reply at 12 n.15; Bell Atlantic comments at 30; Cincinnati Bell comments at 19 (arguing that unbundling of operator services would impose large costs on smaller incumbent LECs); GTE comments at 44 (section 271 requires nondiscriminatory access to call completion services, not unbundled access to the relevant databases); PacTel reply at 21; SBC comments at 83-84; USTA reply at 17-18.

[1287] MCI comments at 37; AT&T reply at 21 (incumbent LECs must unbundle operator systems so that a competitor providing its own does not have to pay for the incumbent LECs' services).

[1288] AT&T comments at 26.

[1289] ACSI comments at 44.

[1290] *See* SBC reply at 22-23.

[1291] MCI comments at 37.

[1292] Unbranded or rebranded operator services involve the provision of such services by the incumbent LEC for the requesting carrier either: (1) without any identification to the customer that it is the incumbent LEC actually providing such services; or (2) in a manner that the incumbent LEC identifies itself to the customer solely as the requesting carrier for the provision of these services.

[1293] ACSI comments at 47-48; AT&T comments at 26; GCI comments at 12.

532. Many commenters argue that directory assistance and the databases used to provide such services should be separately unbundled as a network element.[1294] Some commenters advocate requiring incumbent LECs to provide unbranded directory assistance as a network element.[1295] MCI notes that Pacific Bell operates a joint directory assistance database for itself and GTE, and argues that competing carriers should be able to participate in a similar type arrangement with incumbent LECs.[1296]

533. Some commenters argue that access to "subscriber numbers" should be unbundled and that access to the Number Assignment database should be unbundled.[1297] MCI advocates that the Commission require incumbent LECs to provide unbundled access to their subscriber number information sufficient for the provision of directory assistance and call completion service by competing carriers using their own operators.[1298] Other parties argue that such access should not be required.[1299]

c. Discussion

(1) Operator Services and Directory Assistance

534. We conclude that incumbent LECs are under the same duty to permit competing carriers nondiscriminatory access to operator services and directory assistance facilities as all LECs are under section 251(b)(3).[1300] We further conclude that, if a carrier requests an incumbent LEC to unbundle the facilities and functionalities providing operator services and directory assistance as separate network elements, the incumbent LEC must provide the

[1294] NCTA comments at 42; Teleport comments at 37; GST comments at 25; GCI comments at 12; MCI comments at 37 (MCI further recognizes directory assistance and directory listings).

[1295] Comcast comments at 20; Citizens Utilities comments at 15.

[1296] MCI comments at 33, 38 (California Commission ruling adopting this requirement is published at *Re GTE California Incorporated*, 31 CPUC 2d, 370 (1989)).

[1297] MCI comments at 19-20; ACSI comments at 43.

[1298] MCI comments at 37.

[1299] GTE comments at 43 (to the extent "subscriber numbers" means number administration, nondiscriminatory access is assured by industry guidelines and the Commission's intent to establish a number administration entity); Cincinnati Bell comments at 19 (subscriber numbers and information sufficient for billing and collection should be addressed in the bona fide request process).

[1300] *SeeNPRM* at paras. 203-219.

competing provider with nondiscriminatory access to such facilities and functionalities at any technically feasible point. We believe that these facilities and functionalities are important to facilitate competition in the local exchange market. Further, the 1996 Act imposes upon BOCs, as a condition of entry into in-region interLATA services the duty to provide nondiscriminatory access to directory assistance services and operator call completion services.[1301] We therefore conclude that unbundling facilities and functionalities providing operator services and directory assistance is consistent with the intent of Congress.

535. As discussed in our section on nondiscriminatory access under section 251(b)(3),[1302] the provision of nondiscriminatory access to operator services and directory assistance must conform to the requirements of section 222, which restricts carrier's use of CPNI.[1303] In particular, access to directory assistance and underlying directory information does not require incumbent LECs to provide access to unlisted or unpublished telephone numbers, or other information that the incumbent LEC's customer has requested the LEC not to make available. In conforming to section 222, we anticipate that incumbent LECs will provide such access in a manner that will protect against the inadvertent release of unlisted customer names and numbers.

536. We note that several competitors advocate unbundling the facilities and functionalities providing operator services and directory assistance from particular resold services or the unbundled local switching element, so that a competing provider can provide these services to its customers supported by its own systems rather than those of the incumbent LEC.[1304] Some incumbent LECs argue that such unbundling, however, is not technically feasible because of their inability to route individual end user calls to multiple systems.[1305] We find that unbundling both the facilities and functionalities providing operator services and directory assistance as separate network elements will be beneficial to competition and will aid the ability of competing providers to differentiate their service from the incumbent LECs. We also note that the Illinois Commission has recently ordered such

[1301] 47 U.S.C. § 271(c)(2)(B)(vii)(II)-(III).

[1302] *SeeNPRM* at paras. 203-219.

[1303] *See Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and other Customer Information*, CC Docket No. 96-115, Notice of Proposed Rulemaking, FCC 96-221 (rel. May 17, 1996).

[1304] *See, e.g.*, AT&T comments at 26; Cable & Wireless comments at 20; Colorado Commission comments at 24; DOJ comments at 21; Frontier comments at 17 n.32; MCI comments at 18-20; Jones Intercable reply at 30.

[1305] SBC reply at 22-23.

access.[1306] We therefore find that incumbent LECs must unbundle the facilities and functionalities providing operator services and directory assistance from resold services and other unbundled network elements to the extent technically feasible. As discussed above in our section on unbundled switching, we require incumbent LECs, to the extent technically feasible, to provide customized routing, which would include such routing to a competitor's operator services or directory assistance platform.[1307]

537. We also note that some competitors seek access to operator services and directory assistance in order to serve their own customers.[1308] Some of these parties argue that nondiscriminatory access to such network elements requires incumbent LECs to provide rebranded operator call completion services and directory assistance to the competing carrier's customers.[1309] Incumbent LECs argue that the provision of these services on an unbranded or rebranded basis is not technically feasible because of their inability at the operator services or directory assistance platforms to identify the carrier serving the end user.[1310] As we concluded in our discussion on section 251(b)(3), we find that incumbent LECs must permit nondiscriminatory access to both operator services and directory assistance in the same manner required of all LECs.[1311] We make no finding on the technical feasibility of providing branded or unbranded service to competitors based on the record before us. We note, however, that the Illinois Commission has ordered incumbent LECs to provide rebranded operator call completion services and directory assistance to requesting competitive carriers.[1312]

538. As discussed above, incumbent LECs must provide access to databases as unbundled network elements.[1313] We find that the databases used in the provision of both operator call completion services and directory assistance must be unbundled by incumbent

[1306] *See Illinois Wholesale Order.*

[1307] *See infra*, Section V.I.2.

[1308] AT&T comments at 26.

[1309] ACSI comments at 47-48; AT&T comments at 26; Comcast comments at 20; GCI comments at 12.

[1310] SBC reply at 22-23.

[1311] *See NPRM* at paras. 203-219.

[1312] *See Illinois Wholesale Order.*

[1313] *See supra*, Section V.J.

LECs upon a request for access by a competing provider. In particular, the directory assistance database must be unbundled for access by requesting carriers.[1314] Such access must include both entry of the requesting carrier's customer information into the database, and the ability to read such a database, so as to enable requesting carriers to provide operator services and directory assistance concerning incumbent LEC customer information. We clarify, however, that the entry of a competitor's customer information into an incumbent LEC's directory assistance database can be mediated by the incumbent LEC to prevent unauthorized use of the database. We find that the arrangement ordered by the California Commission concerning the shared use of such a database by Pacific Bell and GTE is one possible method of providing such access.[1315]

539. Section 251(d)(2)(A) requires the Commission to consider whether "access to such network elements as are proprietary in nature is necessary."[1316] Parties generally did not identify proprietary concerns with unbundling access to operator call completion services or directory assistance. Incumbent LECs generally did not claim a proprietary interest in their directory assistance databases. Many parties contend that proprietary interests leading to restrictions on use or sharing of such database information would injure their ability to compete effectively for local service.[1317] For the reasons described below, we find that access to the systems supporting both operator call completion services and directory assistance is necessary for new entrants to provide competing local exchange service.

540. Section 251(d)(2)(B) requires the Commission to consider whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer."[1318] Parties identified access to operator call completion services and directory assistance as critical to the provision of local service.[1319] Therefore we conclude that competitors' ability to provide service would be significantly impaired if they did not have access to incumbent LECs' operator call completion services and directory assistance.

[4] We find the joint directory assistance database used by Pacific Bell and GTE to be one method of such access. MCI comments at 38.

See Re GTE California Incorporated, 31 CPUC 2d 370 (1989).

47 U.S.C. § 251(d)(2)(A).

MCI comments at 37-38.

47 U.S.C. § 251(d)(2)(B).

MCI comments at 37-38.

(2) Subscriber Numbers

541. Some commenters argue that the Commission should require incumbent LECs to unbundle access to subscriber numbers. We conclude that no Commission action under section 251(b)(3) is required at this time to ensure nondiscriminatory access to subscriber numbers. Issues regarding access to subscriber numbers will be addressed by our implementation of section 251(e).[1320]

[1320] *See Number Portability Order.*

VI. METHODS OF OBTAINING INTERCONNECTION AND ACCESS TO UNBUNDLED ELEMENTS

542. In this section, we address the means of achieving interconnection and access to unbundled network elements that incumbent LECs are required to make available to requesting carriers.

A. Overview

1. Background

543. Section 251(c)(2) requires incumbent LECs to provide interconnection with the LEC's network "for the facilities and equipment of any requesting telecommunications carrier."[1321] Section 251(c)(6) imposes upon incumbent LECs "the duty to provide . . . for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the [LEC], except that the carrier may provide for virtual collocation if the [LEC] demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations."[1322] In the NPRM, we noted that section 251(c)(6) does not expressly limit the Commission's authority under section 251(c)(2) to establish rules requiring incumbent LECs to make available a variety of methods of interconnection, except in situations where the incumbent can demonstrate to the state commission that physical collocation is not practical for technical reasons or space limitations. We tentatively concluded that the Commission has the authority to require any reasonable method of interconnection, including physical collocation, virtual collocation, and meet point interconnection arrangements.[1323]

[1321] 47 U.S.C. § 251(c)(2).

[1322] 47 U.S.C. § 251(c)(6).

[1323] NPRM at para. 64. Under the Commission's *Expanded Interconnection* rules, LECs are not required to offer a collocating carrier a choice between physical and virtual collocation. *Special Access Order*, 7 FCC Rcd at 7407; *Switched Transport Order*, 8 FCC Rcd at 7404; *see also Physical Collocation Designation Order*, 8 FCC Rcd 4589 (under our *Expanded Interconnection* rules, LECs must provide virtual collocation where: virtual collocation is available on an intrastate basis; a LEC has negotiated an interstate virtual collocation arrangement; LECs are exempted from providing physical collocation because of space constraints; or a state commission has granted a waiver). Also, *see* Section VI.B.1.b, regarding the definitions of physical and virtual collocation.

2. Comments

544. Many parties agree with our tentative conclusion that we have the authority to require any reasonable method of interconnection.[1324] The Illinois Commission states that the purpose of 251(c)(6) is to eliminate any question about the Commission's authority to require physical collocation, and not to limit the type of interconnection incumbent LECs are required to provide under 251(c)(2).[1325]

545. CAPs and IXCs argue that incumbent LECs should be required to offer competitive entrants the choice between physical and virtual collocation, regardless of whether it is practical to offer physical collocation at a particular LEC premises.[1326] Consumer Federation of America and the Consumers Union argue that the Commission can and should order physical and virtual collocation.[1327] MCI contends that interconnectors have the right to choose virtual or physical collocation, or both, and should have the right to switch from one arrangement to another while paying only the actual costs of such a change.[1328] Sprint argues that the authority to require physical collocation necessarily includes the authority to require less invasive forms of collocation, such as virtual.[1329] Hyperion contends that small carriers lack the financial resources to make the economic investment necessary for physical collocation at every end office. Hyperion suggests that permitting new entrants to request virtual or physical collocation, depending upon their requirements would encourage

[1324] *See, e.g.*, MFS comments at 17-18 (if Congress meant that 251(c)(6) collocation was the exclusive means of obtaining interconnection or access to unbundled elements, then subsections (c)(2) and (c)(3) would not have been required); Teleport comments at 26; Citizens Utilities comments at 11; Illinois Commission comments at 33; Pennsylvania Commission comments at 22; Sprint reply at 21.

[1325] Illinois Commission comments at 33; MFS comments at 18 (no inference can be drawn that Congress intended any limitation on the Commission's authority to require forms of interconnection other than physical collocation, especially in light of section 251(i)).

[1326] *See, e.g.*, AT&T comments at 41; Hyperion comments at 14; MFS comments at 23.

[1327] CFA/CU comments at 14.

[1328] MCI comments at 56.

[1329] Sprint Comments at 19.

competition.[1330] ACTA asserts that the cost of converting existing virtual collocation arrangements to physical should be borne by the incumbent LEC.[1331]

546. Several parties urge the Commission to require interconnection at "meet points."[1332] Teleport states that incumbent LECs currently provide meet point interconnection arrangements between one another's facilities and are thus obligated to provide such arrangements to others.[1333] Teleport also claims that requiring meet point arrangements would be pro-competitive because it would allow competitors the flexibility to construct more efficient networks by eliminating the need to match the incumbent LEC's network.[1334]

547. Incumbent LECs respond that the statute does not give the Commission authority to require virtual collocation in addition to physical collocation.[1335] Ameritech argues that Congress specifically addressed collocation in section 251(c)(6), and that it would be inappropriate to mandate virtual collocation pursuant to the general duty under section 251(c)(2) to provide interconnection. It contends that, under principles of statutory construction, the specific language of section 251(c)(6), which provides for virtual collocation only where physical collocation is not practical, should govern the general language of section 251(c)(2).[1336]

548. GTE claims that section 251(c)(2) does not provide for any Commission role in specifying acceptable forms of interconnection.[1337] Bell Atlantic and BellSouth claim that meet point interconnection arrangements are very complex and should not be mandated by the

[1330] Hyperion comments at 15.

[1331] ACTA comments at 16.

[1332] A meet point is a point, designated by two carriers, at which one carrier's responsibility for service begins and the other carrier's responsibility ends.

[1333] Teleport reply at 25; Sprint reply 21-22 (argues for a "mid-span" meet arrangement whereby two carriers' fiber optic cables would be spliced together at a point between two repeaters).

[1334] Teleport reply at 25.

[1335] *See, e.g.*, Bell Atlantic comments at 34; PacTel comments at 36.

[1336] Ameritech comments at 24.

[1337] GTE comments at 22.

Commission or the states, but rather left to the negotiation process.[1338] PacTel argues that incumbent LECs should not be required to develop new network capabilities or expand current network facilities to interconnect with competitors.[1339]

3. Discussion

549. We conclude that, under sections 251(c)(2) and 251(c)(3), any requesting carrier may choose any method of technically feasible interconnection or access to unbundled elements at a particular point. Section 251(c)(2) imposes an interconnection duty at any technically feasible point; it does not limit that duty to a specific method of interconnection or access to unbundled elements.

550. Physical and virtual collocation are the only methods of interconnection or access specifically addressed in section 251. Under section 251(c)(6), incumbent LECs are under a duty to provide physical collocation of equipment necessary for interconnection unless the LEC can demonstrate that physical collocation is not practical for technical reasons or because of space limitations. In that event, the incumbent LEC is still obligated to provide virtual collocation of interconnection equipment. Under section 251, the only limitation on an incumbent LEC's duty to provide interconnection or access to unbundled elements at any technically feasible point is addressed in section 251(c)(6) regarding physical collocation. Unless a LEC can establish that the specific technical or space limitations in subsection (c)(6) are met with respect to physical collocation, we conclude that incumbent LECs must provide for any technically feasible method of interconnection or access requested by a competing carrier, including physical collocation.[1340] If, for example, we interpreted section 251(c)(6) to limit the means of interconnection available to requesting carriers to physical and virtual collocation, the requirement in section 251(c)(2) that interconnection be made available "at any technically feasible point" would be narrowed dramatically to mean that interconnection was required only at points where it was technically feasible to collocate equipment. We are not pursuaded that Congress intended to limit interconnection points to locations only where collocation is possible.

551. Section 251(c)(6) provides the Commission with explicit authority to mandate physical collocation as a method of providing interconnection or access to unbundled elements. Such authority was previously found lacking by the U.S. Court of Appeals for the

[1338] Bell Atlantic comments at 22; BellSouth comments at 23.

[1339] PacTel comments at 19.

[1340] Because we require incumbent LECs to offer virtual collocation in addition to physical collocation, we reject the suggestion of ACTA that the cost of converting from virtual to physical collocation be borne by the incumbent LEC. *See* ACTA comments at 16.

D.C. Circuit in *Bell Atlantic v. FCC*,[1341] which was decided prior to enactment of the 1996 Act. While section 251(c)(6) limits an incumbent LEC's duty to provide physical collocation in certain circumstances, we find that it does not limit our authority to require, under sections 251(c)(2) and (c)(3), the provision of virtual collocation. We note that under our *Expanded Interconnection* rules, that were amended subsequent to the Bell Atlantic decision, competitive entrants using physical collocation were required by many incumbent LECs to convert to virtual collocation. If the Commission concluded that subsection (c)(6) places a limitation on our authority to require virtual collocation, competitive providers would be required to undertake costly and burdensome actions to convert back to physical collocation even if they were satisfied with existing virtual collocation arrangements. We conclude that Congress did not intend to impose such a burden on requesting carriers that wish to continue to use virtual collocation for purposes of section 251(c). Further, the record indicates that this requirement would be costly and would delay competition.[1342] In short, we conclude that, in enacting section 251(c)(6), Congress intended to expand the interconnection choices available to requesting carriers, not to restrict them.

552. We also conclude that requiring incumbent LECs to provide virtual collocation and other technically feasible methods of interconnection or access to unbundled elements is consistent with Congress's desire to facilitate entry into the local telephone market by competitive carriers. In certain circumstances, competitive carriers may find, for example, that virtual collocation is less costly or more efficient than physical collocation. We believe that this may be particularly true for small carriers which lack the the financial resources to physically collocate equipment in a large number of incumbent LEC premises.[1343] Moreover, since requesting carriers will bear the costs of other methods of interconnection or access, this approach will not impose an undue burden on the incumbent LECs.

553. Consistent with this view, other methods of technically feasible interconnection or access to incumbent LEC networks, such as meet point arrangements, in addition to virtual

[1341] *Bell Atlantic Telephone Companies v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994) (Bell Atlantic v. FCC).

[1342] *See* Teleport comments at 32; ALTS comments at 23; Time Warner comments at 42-44 (objecting to non-recurring charges for the reconnection of existing interconnected virtual collocation services to a replacement physical collocation arrangement).

[1343] *See* Hyperion comments at 15.

and physical collocation, must be available to new entrants upon request.[1344] Meet point arrangements (or mid-span meets), for example, are commonly used between neighboring LECs for the mutual exchange of traffic, and thus, in general, we believe such arrangements are technically feasible.[1345] Further, although the creation of meet point arrangements may require some build out of facilities by the incumbent LEC, we believe that such arrangements are within the scope of the obligations imposed by sections 251(c)(2) and 251(c)(3). In a meet point arrangement, the "point" of interconnection for purposes of sections 251(c)(2) and 251(c)(3) remains on "the local exchange carrier's network"[1346] (*e.g.*, main distribution frame, trunk-side of the switch), and the limited build-out of facilities from that point may then constitute an accommodation of interconnection.[1347] In a meet point arrangement each party pays its portion of the costs to build out the facilities to the meet point. We believe that, although the Commission has authority to require incumbent LECs to provide meet point arrangements upon request, such an arrangement only makes sense for interconnection pursuant to section 251(c)(2) but not for unbundled access under section 251(c)(3). New entrants will request interconnection pursuant to section 251(c)(2) for the purpose of exchanging traffic with incumbent LECs. In this situation, the incumbent and the new entrant are co-carriers and each gains value from the interconnection arrangement. Under these circumstances, it is reasonable to require each party to bear a reasonable portion of the economic costs of the arrangement. In an access arrangement pursuant to section 251(c)(3), however, the interconnection point will be a part of the new entrant's network and will be used to carry traffic from one element in the new entrant's network to another. We conclude that in a section 251(c)(3) access situation, the new entrant should pay all of the economic costs of a meet point arrangement. Regarding the distance from an incumbent LEC's premises that an incumbent should be required to build out facilities for meet point arrangements, we believe that the parties and state commissions are in a better position than the Commission to determine the appropriate distance that would constitute the required reasonable accommodation of interconnection.

[1344] *See* Teleport comments at 26-30; *see also* Washington Utilities and Transportation Commission, *Fourth Supplemental Order Rejecting Tariff Filings and Ordering Refiling*; Granting Complaints, in Part, (Washington Commission Oct. 31, 1995), Docket No. UT-941464, at 45; *Application of Electric Lightwave, Inc., MFS Intelnet of Oregon, Inc., and MCI Metro Access Transmission Services, Inc.*, Public Utility Commission of Oregon Order, Order No. 96-021, (Oregon Commission Jan. 12, 1996), at 68-69; *Rules for Telecommunications Interconnection and Unbundling*, Arizona Corporation Commission Order, Decision No. 59483, (Arizona Commission Jan. 11, 1996), Proposed Rule R14-2-1303 (Attachment E hereto).

[1345] The Michigan Commission recently required Ameritech to provide meet point interconnection. Michigan Public Service Commission, Case No. U-10860 (Michigan June 5, 1996) at 18 n.4.

[1346] 47 U.S.C. § 251(c)(2).

[1347] *See, supra* Section IV.E., above, discussing accommodation of interconnection.

554. Finally, in accordance with our interpretation of the term "technically feasible," we conclude that, if a particular method of interconnection is currently employed between two networks, or has been used successfully in the past, a rebuttable presumption is created that such a method is technically feasible for substantially similar network architectures. Moreover, because the obligation of incumbent LECs to provide interconnection or access to unbundled elements by any technically feasible means arises from sections 251(c)(2) and 251(c)(3), we conclude that incumbent LECs bear the burden of demonstrating the technical infeasibility of a particular method of interconnection or access at any individual point.

B. Collocation

1. Collocation Standards

a. Adoption of National Standards

(1). Background

555. In the NPRM we tentatively concluded that we should adopt national rules for virtual and physical collocation. This tentative conclusion was based on the belief that national standards would help to speed the development of competition.[1348] We also sought comment on specific national standards that we might adopt, and on whether any specific state approaches would serve as an appropriate model.[1349]

(2). Comments

556. Incumbent LECs and state commissions argue that collocation is a state matter and that terms and conditions for collocation should be negotiated between the parties[1350] or determined by the states.[1351] Some parties recommend that, to the extent national guidelines are necessary, the Commission should readopt the standards established in the *Expanded*

[1348] NPRM at para. 24.

[1349] NPRM at para. 70.

[1350] BellSouth comments at 23; SBC comments at 64; USTA comments at 19; PacTel comments at 34.

[1351] *See, e.g.*, New York Commission comments at 13-14; *see also* Ohio Commission comments at 29; Florida Commission comments at 22; Oregon Commission comments at 23.

Interconnection proceeding.[1352] Teleport and the New York Commission suggest that, if we adopt rules, we should use the New York Commission's "comparably efficient interconnection" standard as a model.[1353] The Alabama and Missouri Commissions support the approach to interconnection that each adopted in their respective states.[1354] Pacific Telesis supports California's "preferred outcomes approach."[1355]

557. Competitive providers generally favor national standards for collocation.[1356] MFS argues that Congress did not intend for the states to have a policy role in collocation matters, and that unambiguous national guidelines are needed to prevent incumbent LECs from engaging in discriminatory practices and to avoid duplicative litigation in multiple forums.[1357]

(3). Discussion

558. We conclude that we should adopt explicit national rules to implement the collocation requirements of the 1996 Act. We find that specific rules defining minimum requirements for nondiscriminatory collocation arrangements will remove barriers to entry by potential competitors and speed the development of competition. Our experience in the *Expanded Interconnection* proceeding indicates that incumbent LECs have an economic

[1352] USTA comments at 19; Bell Atlantic comments at 32-33; Sprint reply at 22; California Commission comments at 24, Texas Commission comments at 13-14; District of Columbia Commission comments at 20.

[1353] Teleport comments at 30 (this standard is consistent with, if not demanded by, the requirements for nondiscriminatory interconnection in section 251(c)(2)(C)); New York Commission comments at 34 (the Commission should not set specific rules, but should adopt guidelines that incumbent LECs offer comparably efficient interconnection).

[1354] Alabama Commission comments at 17 (under Alabama's interconnection model, parties negotiate collocation arrangements and may petition the Alabama commission to require collocation under specific terms and conditions should negotiations fail); Missouri Commission comments at 12 (The Missouri Commission requires the incumbent LEC to provide the type of interconnection that the interconnecting carrier requests, either physical or virtual. The Commission also requires that large incumbent LECs tariff their interconnection arrangements, and that collocators pay a deposit).

[1355] PacTel comments at 36.

[1356] Intermedia comments at 6; Teleport comments at 30; ALTS comments at 21; Hyperion comments at 14; ACSI comments at 14; NCTA comments at 34; Telecommunications Resellers Ass'n comments at 46; Time Warner comments at 32; MFS comments at 20-21; AT&T comments at 39.

[1357] MFS comments at 20-21.

incentive to interpret regulatory ambiguities to delay entry by new competitors.[1358] We and the states should therefore adopt, to the extent possible, specific and detailed collocation rules. We find, however, that states should have flexibility to apply additional collocation requirements that are otherwise consistent with the 1996 Act and our implementing regulations.

b. Adoption of *Expanded Interconnection* Terms and Conditions for Physical and Virtual Collocation under Section 251

(1). Background

559. In our *Expanded Interconnection* proceeding, we required LECs to offer expanded interconnection to all interested parties, which allowed competitors and end users to terminate their own special access and switched transport access transmission facilities at LEC central offices.[1359] We required Tier 1 LECs[1360] to offer physical collocation, with the interconnecting party paying the LEC for central office floor space.[1361] We required that LECs provide space to interested parties on a first-come first-served basis, and that they

[1358] Our review of the LECs' initial physical and virtual collocation tariffs raised significant concerns regarding the implementation of our *Expanded Interconnection* requirements and resulted in the designation of numerous issues for investigation. The Commission has not yet reached decisions on most of these issues, though it has found that certain rates for virtual collocation were unlawful. *See Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Virtual Collocation for Special Access and Switched Transport*, 10 FCC Rcd 6375 (Com. Car. Bur. 1995)(*Phase I Report and Order*); *see also Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection for Special Access*, 8 FCC Rcd 6909 (Com. Car. Bur. 1993) (*Physical Collocation Designation Order*); *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through* Virtual Collocation for Special Access and Switched Transport, 10 FCC Rcd 11116 (Com. Car. Bur. 1995)(*Virtual Collocation Designation Order*).

[1359] *Expanded Interconnection with Local Telephone Company Facilities, First Report and Order*, 7 FCC Rcd 7369 (1992)(*Special Access Order*), *vacated in part and remanded, Bell Atlantic*, 24 F.3d 1441 (1994); *First Reconsideration*, 8 FCC Rcd 127 (1993); *vacated in part and remanded, Bell Atlantic*, 24 F.3d 1441; *Second Reconsideration*, 8 FCC Rcd 7341 (1993); *Second Report and Order*, 8 FCC Rcd 7374 (1993)(*Switched Transport Order*), *vacated in part and remanded, Bell Atlantic Telephone Cos., v. FCC*, 24 F.3d 1441; *Remand Order*, 9 FCC Rcd 5154 (1994)(*Virtual Collocation Order*), *remanded for consideration of 1996 Act, Pacific Bell, et al. v. FCC*, 81 F.3d 1147 (1996) (collectively referred to as *Expanded Interconnection)*. Interstate access is a service traditionally provided by local telephone companies and enables IXCs and other customers to originate and terminate interstate telephone traffic. Special access is a form of interstate access that uses dedicated transmission lines between two points, without switching the traffic on those lines. Switched transport is another form of interstate access comprising the transmission of traffic between interexchange carriers' (or other customers') points of presence and local telephone companies' end offices, where the traffic is switched and routed to end users.

[1360] Tier 1 LECs are local exchange carriers having $100 million or more in "total company annual regulated revenues." *Commission Requirements for Cost Support Material to be Filed with 1990 Annual Access Tariffs*, 5 FCC Rcd 1364, 1364 (Com. Car. Bur. 1990)(*1990 Cost Support Order*).

[1361] The interconnecting party uses the space to locate equipment necessary to terminate its transmission links for interconnection with the LEC's network. The interconnector has physical access to this space in the LEC central office to install, maintain, and repair its transmission equipment. *Special Access Order*, 7 FCC Rcd at 7391.

provide virtual collocation when space for physical collocation is exhausted.[1362] Under virtual collocation, interconnectors are allowed to designate central office transmission equipment dedicated to their use, as well as to monitor and control their circuits terminating in the LEC central office. Interconnectors, however, do not pay for the incumbent's floor space under virtual collocation arrangements and have no right to enter the LEC central office. Under our virtual collocation requirements, LECs must install, maintain, and repair interconnector-designated equipment under the same intervals and with the same or better failure rates for the performance of similar functions for comparable LEC equipment.[1363]

560. In the *Expanded Interconnection* proceeding, we required the LECs to file tariffs to implement our virtual and physical collocation requirements. Our initial review of the LECs' tariffs raised significant concerns regarding the LECs' provision of physical and virtual collocation.[1364] Consequently, the Bureau partially suspended the rates proposed by many of the LECs and allowed these rates to take effect subject to investigation and an accounting order.

561. In 1994, the U.S. Court of Appeals for the District of Columbia Circuit found that the FCC lacked the authority under section 201 of the 1934 Communications Act to require physical collocation and remanded all other issues to the Commission.[1365] On remand, we adopted rules for both special access and switched transport that required LECs to provide either virtual or physical collocation, at the LECs' option.[1366] Those rules currently are in place, although the court of appeals remanded the *Remand Order* to us to consider the impact of the 1996 Act on those rules.[1367] In the 1996 Act, Congress specifically directed incumbent LECs to provide physical collocation for interconnection and access to unbundled network

[1362] 7 FCC Rcd at 7391.

[1363] *Special Access Order*, 7 FCC Rcd at 7394; *Switched Transport Order*, 8 FCC Rcd at 7393.

[1364] *See Special Access Physical Collocation Designation Order*, 8 FCC Rcd 6909; *Virtual Collocation Designation Order*, 10 FCC Rcd 11116; *see also supra*, note 1358.

[1365] *Bell Atlantic v. FCC*, 24 F.3d 1441.

[1366] *Remand Order*, 9 FCC Rcd 5154.

[1367] *Pacific Bell et al. v. FCC*, 81 F.3d 1147 (D.C. Cir. 1996). As discussed in Section VI.B.2.a, below, we find that the 1996 Act does not supplant or otherwise alter our *Expanded Interconnection* rules for interstate interconnection services provided pursuant to section 201 of the Communications Act.

elements, absent technical or space constraints, pursuant to section 251(c)(6) of the Communications Act.[1368]

562. We sought comment in the NPRM on whether, for purposes of implementing physical and virtual collocation under section 251, we should readopt the standards set out in our *Expanded Interconnection* proceeding and, if so, how to adapt those standards to reflect the new statutory requirements and other policy considerations of the 1996 Act.[1369]

(2). Comments

563. To the extent parties addressed the substantive content of national rules, most favor readoption of the *Expanded Interconnection* rules. Assuming that national standards are to be adopted, several state commissions and a number of incumbent LECs generally favor readoption of our *Expanded Interconnection* requirements because they were developed based on an extensive record.[1370] BellSouth, in contrast, argues that the Commission's *Expanded Interconnection* rules are no longer necessary under the 1996 Act, because parties should be free to negotiate agreements between themselves without being governed by FCC rules.[1371] SBC and Pacific Telesis argue that physical collocation should be negotiated in order to allow parties to address unique requirements.[1372] Cincinnati Bell argues that the FCC should not establish regulations regarding services that are ancillary to collocation such as rent, insurance, and equipment maintenance, because they are not activities within the purview of Title II of the Communications Act.[1373]

[1368] 47 U.S.C. § 251(c)(6).

[1369] NPRM at para. 71.

[1370] Bell Atlantic comments at 33; Cincinnati Bell comments at 15; PacTel comments at 35; NYNEX comments at 66; Roseville Tel. comments at 2-3; SNET comments at 15; GTE comments at 24 (*Expanded Interconnection* rules should be readopted if used to identify acceptable outcomes and not to dictate behavior); *see also* Alabama Commission comments at 17; Texas Commission comments at 14; Illinois Commission comments at 35.

[1371] BellSouth comments at 24 (the Act sets up a new framework under which the parties must be free to negotiate arrangements "unencumbered by excessive rules and regulations").

[1372] PacTel reply at 12; SBC comments at 64 (collocation should be negotiated and should not be subject to uniform requirements because of the differing conditions at each location).

[1373] Cincinnati Bell comments at 15.

564. CAPs and IXCs also generally favor readoption of our *Expanded Interconnection* requirements.[1374] Several commenters advocate specific amendments that they believe are required by the 1996 Act or by intervening circumstances.[1375] MFS, however, argues that the purposes of the 1996 Act are much broader than those of the *Expanded Interconnection* proceedings and that the collocation standards under section 251 should reflect this difference.[1376] MCI contends that existing collocation rules, terms, and conditions should be significantly modified.[1377] Teleport asserts that the Commission should require all incumbent LECs to refile with the FCC their most recent physical collocation tariffs, subject to the previously applicable accounting orders.[1378]

(3). Discussion

565. We conclude that we should adopt the existing *Expanded Interconnection* requirements, with some modifications, as the rules applicable for collocation under section 251.[1379] Those rules were established on the basis of an extensive record in the *Expanded Interconnection* proceeding, and are largely consistent with the requirements of section 251(c)(6). Adoption of those requirements for purposes of collocation under section 251, moreover, has substantial support in the record of this proceeding. Thus, the standards established for physical and virtual collocation in our *Expanded Interconnection* proceeding will generally apply to collocation under section 251. The most significant requirements of *Expanded Interconnection* are specifically set out in rules we adopt here. We address pricing and rate structure issues separately, in section VII below.

566. We find, however, that certain modifications to our *Expanded Interconnection* requirements are necessary to account for specific provisions of section 251(c)(6) and service

[1374] *See, e.g.*, Sprint comments at 21; Time Warner comments at 38; Intermedia comments at 6.

[1375] ALTS comments at 24; Telecommunications Resellers Ass'n comments at 47; Intermedia comments at 9 (incumbent LECs must tariff cross-connect elements for services not currently offered, such as packet switching, frame relay, ATM, and SONET services); ACSI comments at 16 (revised *Expanded Interconnection* rules should reflect resolution of issues raised in designation orders).

[1376] MFS comments at 22; *see also* MCI comments at 54.

[1377] MCI comments at 58.

[1378] Teleport comments at 31; Intermedia comments at 7 (arguing that LECs must establish terms and conditions for physical collocation within 30 days).

[1379] *See Remand Order*, 9 FCC Rcd at 5168-69, 5174-83.

arrangements that differ from those contemplated in our *Expanded Interconnection* orders.[1380] For example, the *Expanded Interconnection* requirements apply to Tier 1 LECs that are not NECA pool members, and section 251 applies to "incumbent LECs," though there is an exemption for certain rural carriers.[1381] *Expanded Interconnection* also allows end-users to interconnect their equipment, while section 251 requires that interconnection and access to unbundled network elements be provided to "any requesting telecommunications carrier."[1382] Accordingly, we set forth below several modifications to the terms and conditions for collocation as they are described in our *Expanded Interconnection* orders for application in implementing section 251. We believe that, in light of the expedited statutory time frame for this rulemaking and limited record addressing the specific terms and conditions for collocation under section 251 in this proceeding, it would be impractical and imprudent to develop a large number of new substantive collocation requirements in this order. We may consider the need for additional or different requirements in a subsequent proceeding, if we determine that such action is warranted.

567. The most significant difference between the *Expanded Interconnection* rules and the collocation rules we adopt to implement the 1996 Act concerns the collocation tariffing requirement. As discussed below, the 1996 Act does not require that collocation be federally tariffed.[1383] We thus do not adopt, under section 251, the *Expanded Interconnection* tariffing requirements originally adopted under section 201 for physical and virtual collocation. The existing tariffing requirements of *Expanded Interconnection* for interstate special access and switched transport will continue to apply for use by customers that wish to subscribe to those interstate services.[1384]

568. We reject SBC's contention that we may not adopt any terms and conditions in this proceeding that differ from those in the *Expanded Interconnection* proceeding. SBC argues that Congress intended, in section 251(c)(6), to use the term "physical collocation" as a term of art, and thereby to adopt wholesale the terms and conditions for physical collocation that the Commission adopted in the *Expanded Interconnection* proceeding. A variety of terms and conditions for physical collocation are possible and section 251(c)(6) makes no reference to the Commission's decisions on these issues in the *Expanded Interconnection* proceeding. If

[1380] *See supra*, note 1358, 1359.

See infra, Section XII.

See 47 U.S.C. § 251(c)(2), (3).

See infra, Section VI.B.2.a.

See infra, Section VI.B.2.a.

Congress had intended to readopt those rules wholesale without permitting the Commission any flexibility in the matter, we believe that Congress would have been more explicit rather than merely using the phrase "physical collocation." Thus, we believe that we can and should modify our preexisting standards, as set forth below, for purposes of implementing the provisions of section 251(c)(6). In the following sections (c. - i.) we address comments filed by interested parties concerning application of our existing *Expanded Interconnection* requirements for purposes of collocation under section 251.[1385]

569. Finally, our experience reviewing the tariffs that incumbent LECs filed to implement our requirements for physical and virtual collocation suggests that rates, terms, and conditions under which incumbent LECs propose to provide these arrangements pursuant to section 251(c)(6) bear close scrutiny.[1386] We strongly urge state commissions to be vigilant in their review of such arrangements.[1387] We will review this issue and revise our requirements as necessary.

c. The Meaning of the Term "Premises"

(1). Background

570. In the *Expanded Interconnection* proceeding, we required collocation at end offices, serving wire centers, and tandem switches, as well as at remote distribution nodes and any other points that the LEC treats as a "rating point."[1388] Section 251(c)(6) requires physical collocation "at the premises of the local exchange carrier."[1389] In the NPRM, we tentatively concluded that the term "premises" includes, in addition to LEC central offices and tandem offices, all buildings or similar structures owned or leased by the incumbent LEC that house LEC network facilities. We sought comment on whether structures that house LEC

[1385] In a number of instances, we decline to adopt proposals for modifications to our *Expanded Interconnection* requirements.

[1386] *See Special Access Physical Collocation Designation Order*, 8 FCC Rcd 6909; *Virtual Collocation Designation Order*, 10 FCC Rcd 11116.

[1387] Some areas our investigations have found problematic in the past include channel assignment, letters of agency, charges for repeaters, and placement of point-of-termination bays.

[1388] *See Remand Order*, 9 FCC Rcd at 5168; *Special Access Order*, 7 FCC Rcd at 7418; *Switched Transport Order*, 8 FCC Rcd at 7409. A rating point is a point used in calculating the length of interoffice special access links.

[1389] 47 U.S.C. § 251(c)(6).

network facilities on public rights-of-way, such as vaults containing loop concentrators or similar structures, should be deemed to be LEC "premises."[1390]

(2). Comments

571. Incumbent LECs generally argue that collocation is infeasible at locations other than central offices, tandem switching locations, and remote nodes, and that only such locations should be included in the interpretation of the word "premises."[1391] Pacific Telesis argues that points for collocation cannot be determined until the Commission determines the points of interconnection and access to unbundled network elements.[1392] Ameritech contends that we should define the term "premises" as only those portions of central office buildings in which the LEC has the exclusive right of occupancy and in which the technically feasible point of interconnection or access to unbundled elements is located.[1393] The Rural Tel. Coalition asks that interconnection and collocation points be established in a flexible manner to recognize size and volume differences among carriers.[1394]

572. CAPs and IXCs generally favor an expansive definition of the term "premises" that includes "structures housing LEC network facilities on public rights-of-way including vaults containing loop concentrators or similar structures."[1395] These commenters argue that physical collocation should be offered at any incumbent LEC location where physical collocation is technically feasible, including central offices, cable vaults, manholes, cross-connect points, loop carrier, and building closets.[1396] ALTS and MFS contend that assertions of technical infeasibility should be addressed in fact-specific situations and should not narrow

[1390] NPRM at para. 72.

[1391] *See, e.g.*, USTA comments at 20; NYNEX comments at 66; Cincinnati Bell comments at 15; Ameritech comments at 22 (the term "premises" should only include central offices housing network facilities in which the incumbent LEC has the exclusive right of occupancy).

[1392] Bell Atlantic comments at 37.

[1393] Ameritech comments at 22.

[1394] Rural Tel. Coalition comments at 31.

[1395] *See, e.g.*, AT&T comments at 40; *see also* Telecommunications Resellers Ass'n comments at 46; Hyperion comments at 14.

[1396] *See, e.g.*, MFS comments at 23.

the general application of section 251(c)(6).[1397] The Illinois Commission supports our tentative conclusion and argues that collocation should not be restricted to central and tandem offices.[1398]

(3). Discussion

573. The 1996 Act does not address the definition of premises, nor is the term discussed in the legislative history. Therefore, we look to the purposes of the 1996 Act and general uses of the term "premises" in other contexts in order to define this term for purposes of section 251(c)(6). The term "premises" is defined in varying ways, according to the context in which it is used.[1399] In light of the 1996 Act's procompetitive purposes, we find that a broad definition of the term "premises" is appropriate in order to permit new entrants to collocate at a broad range of points under the incumbent LEC's control. A broad definition will allow collocation at points other than those specified for collocation under the existing *Expanded Interconnection* requirements. We find that this result is appropriate because the purposes of physical and virtual collocation under section 251 are broader than those established in the *Expanded Interconnection* proceeding. We therefore interpret the term "premises" broadly to include LEC central offices, serving wire centers and tandem offices, as well as all buildings or similar structures owned or leased by the incumbent LEC that house LEC network facilities. We also treat as incumbent LEC premises any structures that house LEC network facilities on public rights-of-way, such as vaults containing loop concentrators or similar structures.

574. As discussed below, we conclude that section 251(c)(6) requires collocation only where technically feasible. In light of this conclusion, we find that adoption of a definition of "premises" that depends on whether interconnection or access to unbundled network elements at a particular point is "technically feasible," as suggested by Ameritech and Pacific Telesis, would be superfluous. We also conclude that it is not appropriate to adopt a definition of "premises," as suggested by several parties, that is dependent on whether it is "practical" to collocate equipment at a particular point. We note however, that neither

[1397] ALTS reply at 35; MFS reply at 29.

[1398] Illinois Commerce Commission at 33.

[1399] *See Gibbons v. Brandt*, 170 F.2d 385, 387 (7th Cir. 1948) ("the word 'premises' does not have one fixed and absolute meaning. It is to be determined always by its context . . .").

physical nor virtual collocation is required at points where not technically feasible.[1400] We therefore decline to adopt specific requirements regarding collocation at particular points in the LEC network, as suggested by GVNW and others. Because collocation is only required where technically feasible, the approach we here adopt will enable competitors to take advantage of opportunities to collocate equipment without imposing undue burdens on incumbent LECs, whether large or small.

575. We also address the impact on small incumbent LECs. For example, the Rural Tel. Coalition asks that interconnection and collocation points be established in a flexible manner. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, we do not adopt rigid requirements for locations where collocation must be provided. Incumbent LECs are not required to physically collocate equipment in locations where not practical for technical reasons or because of space limitations, and virtual collocation is required only where technically feasible. We also note, however, that section 251(f) of the 1996 Act provides relief to certain small LECs from our regulations implementing section 251.[1401]

d. Collocation Equipment

(1). Background

576. In the *Expanded Interconnection* proceeding, we allowed collocation for central office equipment needed to terminate basic transmission facilities between LEC central offices and third-party premises. Acceptable equipment included optical terminating equipment and multiplexers. We did not require the LECs to permit collocation of enhanced services equipment or customer premises equipment because such equipment was not necessary to foster competition in the provision of basic transmission services. We also did not require LECs to allow the collocation of switches.[1402] Section 251(c)(6) requires incumbent LECs to allow collocation of "equipment necessary for interconnection or access to unbundled elements

[1400] Incumbent LECs are required to permit the collocation of equipment for the purpose of interconnection under section 251(c)(2) or access to unbundled network elements under section 251(c)(3). Interconnection and access to unbundled network elements are only required under these sections at technically feasible points. 47 U.S.C. § 251(c)(2) and (3).

[1401] *See infra*, Section XII.

[1402] *See generally Remand Order*, 9 FCC Rcd at 5178-81 (paras. 82-94); *see also Special Access Order*, 7 FCC Rcd at 7412-16, *Switched Transport Order*, 8 FCC Rcd at 7411-16.

. . . ."[1403] We sought comment in the NPRM on what types of equipment competitors should be permitted to collocate on LEC premises.[1404]

(2). Comments

577. BOCs and other incumbent LECs generally favor limiting the type of equipment allowed to be collocated to transmission equipment necessary to interconnect to LEC networks.[1405] Sprint argues that incumbent LECs should be permitted to limit the amount of space they have to provide to that needed for equipment necessary for the particular type of interconnection that is taking place.[1406] IXCs and CAPs argue that any type of equipment may be collocated absent demonstrable harm to the LEC, and that any arbitrary limit on the types of equipment to be collocated could foreclose efficient methods of interconnection and/or access to unbundled elements.[1407] MFS contends that competing providers should not be required to demonstrate affirmatively that equipment is "necessary" before allowing it to be collocated. The Illinois Commission supports a policy that would not restrict the type of equipment to be collocated except where necessary to prevent harm to the network. The Colorado Commission supports limiting allowable equipment to that used to provide a telecommunications service.[1408] The Association of Telemessaging Services International urges the Commission to require collocation of equipment used to provide enhanced services.[1409]

578. WinStar argues that the 1996 Act establishes its right to place its microwave facilities on the roofs of incumbent LEC buildings in which its termination equipment is to be

---

[1403] 47 U.S.C. § 251(c)(6).

[1404] NPRM at para.72.

[1405] *See, e.g.*, SBC comments at 63-64; Bell Atlantic comments at 34; GTE reply at 14; PacTel comments at 38, reply at 13.

[1406] Sprint reply at 23.

[1407] *See, e.g.*, MFS comments at 24; MCI comments at 54-55; Time Warner comments at 39; GCI comments at 10.

[1408] Illinois Commission comments at 34; Colorado Commission comments at 23.

[1409] Association of Telemessaging Services International reply at 16.

collocated in order to ensure that wireline facilities are not favored over wireless, and therefore urges the Commission to adopt a collocation standard that is technology neutral.[1410]

(3). Discussion

579. We believe that section 251(c)(6) generally requires that incumbent LECs permit the collocation of equipment used for interconnection or access to unbundled network elements. Although the term "necessary," read most strictly, could be interpreted to mean "indispensable," we conclude that for the purposes of section 251(c)(6) "necessary" does not mean "indispensable" but rather "used" or "useful." This interpretation is most likely to promote fair competition consistent with the purposes of the Act. (We note that this view is consistent with the findings of the Colorado Commission).[1411] Thus, we read section 251(c)(6) to refer to equipment used for the purpose of interconnection or access to unbundled network elements.[1412] Even if the collocator could use other equipment to perform a similar function, the specified equipment may still be "necessary" for interconnection or access to unbundled network elements under section 251(c)(6). We can easily imagine circumstances, for instance, in which alternative equipment would perform the same function, but with less efficiency or at greater cost. A strict reading of the term "necessary" in these circumstances could allow LECs to avoid collocating the equipment of the interconnectors' choosing, thus undermining the procompetitive purposes of the 1996 Act.

580. Consistent with this interpretation, we conclude that transmission equipment, such as optical terminating equipment and multiplexers, may be collocated on LEC premises. We also conclude that LECs should continue to permit collocation of any type of equipment currently being collocated to terminate basic transmission facilities under the *Expanded Interconnection* requirements. In addition, whenever a telecommunications carrier seeks to collocate equipment for purposes within the scope of section 251(c)(6), the incumbent LEC shall prove to the state commission that such equipment is not "necessary," as we have defined that term, for interconnection or access to unbundled network elements. State commissions may designate specific additional types of equipment that may be collocated pursuant to section 251(c)(6).

[1410] WinStar comments at 4, reply at 4.

[1411] Colorado Public Utilities Commission, *Proposed Rules Regarding Implementation of §§ 40-15-101* et. seq., *Requirements Relating to Interconnection and Unbundling*, Docket No. 95R-556T, (Colorado Commission, March 29, 1996) at 19-20.

[1412] *Cf. National Railroad Passenger Corporation v. Boston and Maine Corp.*, 503 U.S. 407, 417 (1992) (upholding the ICC's interpretation of the word "required" as "useful or appropriate," rather than "indispensable"); *McCulloch v. Maryland*, 4 Wheat. 316, 413 (1819) (Chief Justice Marshall read the word "necessary" to mean "convenient, or useful," rejecting a stricter reading of the term).

581. We do not find, however, that section 251(c)(6) requires collocation of equipment used to provide enhanced services, contrary to the arguments of the Association of Telemessaging Services International.[1413] We also decline to require incumbent LECs to allow collocation of any equipment without restriction.[1414] Section 251(c)(6) requires collocation only of equipment "necessary for interconnection or access to unbundled elements." Section 251(c)(2) requires incumbent LECs to provide "interconnection" for the "transmission and routing of telephone exchange service and exchange access," and section 251(c)(3) requires incumbent LECs to provide access to unbundled network elements "for the provision of a telecommunications service."[1415] Section 251(c)(6) therefore requires incumbent LECs to provide physical or virtual collocation only for equipment "necessary" or used for those purposes. We find that section 251(c)(6) does not require collocation of equipment necessary to provide enhanced services.[1416] At this time, we do not impose a general requirement that switching equipment be collocated since it does not appear that it is used for the actual interconnection or access to unbundled network elements.[1417] We recognize, however, that modern technology has tended to blur the line between switching equipment and multiplexing equipment, which we permit to be collocated. We expect, in situations where the functionality of a particular piece of equipment is in dispute, that state commissions will determine whether the equipment at issue is actually used for interconnection or access to unbundled elements. We also reserve the right to reexamine this issue at a later date if it appears that such action would further achievement of the 1996 Act's procompetitive goals. Finally, because we lack an adequate record on the issue, we decline to adopt AT&T's

[1413] ATSI reply at 16.

[1414] *See, e.g.*, MFS comments at 24.

[1415] 47 U.S.C. § 251(c)(3).

[1416] We note that we declined to require collocation of enhanced services equipment in our *Computer III* and *ONA* proceedings. *See Third Computer Inquiry*, Report and Order, 104 FCC 2d 958, 1037-38 (1986); *Computer III Remand*, 6 FCC Rcd 7571 (1991). Enhanced services are defined as services that "employ computer processing applications which act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured informatic or involve subscriber interaction with stored information." 47 C.F.R. § 64.702. This definition appears not to include the provision of "telecommunications services." *See* 47 U.S.C. § 153(43), (46).

[1417] If switching equipment is located at the collocated space, generally the only equipment used for interconnection or access to unbundled elements is the cross-connect equipment. The switching equipment generally perform other functions.

proposal that we require that incumbent LECs allow collocated equipment to be used for "hubbing."[1418]

582. In response to WinStar's suggestion that we require collocation of microwave transmission facilities, we note that collocation of microwave transmission equipment was required where reasonably feasible by the *Special Access Order*.[1419] We also require the collocation of microwave equipment under section 251, although we modify the *Expanded Interconnection* standard we adopt under section 251 for when such collocation is required slightly to conform to the standard for the provision of physical collocation in section 251(c)(6). We therefore require that incumbent LECs allow competitors to use physical collocation for microwave transmission facilities except where this is not practical for technical reasons or because of space limitations, in which case virtual collocation is required where technically feasible.[1420]

e. Allocation of Space

(1). Background

583. In the *Expanded Interconnection* proceeding, we required LECs to allocate space for physical collocation on a first-come, first-served basis. We also required LECs to take into account interconnector demand for collocation space when reconfiguring space or building new central offices, and we found that imposing reasonable restrictions on warehousing of space by collocating carriers was appropriate.[1421] The NPRM sought comment on whether national guidelines would deter anticompetitive behavior through the manipulation or unreasonable allocation of space by either incumbent LECs or new entrants.[1422]

(2). Comments

[1418] AT&T advocates requiring LECs to allow new entrants to "connect additional equipment of their own to their collocated equipment in the collocated space." Letter from Betsy Brady, Federal Government Affairs Director and Attorney, to Robert McDonald, Common Carrier Bureau, July 12, 1996, at 3, n.2 (AT&T July 12, 1996 *Ex Parte*). *See also* AT&T comments at 40 n. 51.

[1419] *Special Access Order*, 7 FCC Rcd at 7416; *see also Remand Order*, 9 FCC Rcd at 5178-79.

[1420] Under our technical feasibility standard, the costs of any construction necessary to accommodate the proposed interconnection arrangement are to be borne by the party seeking to interconnect. *See supra*, Section IV.E.

[1421] *Special Access Order*, 7 FCC Rcd at 7408.

[1422] NPRM at para.72.

584. CAPs and IXCs support adoption of rules governing incumbent LEC space allocation. AT&T asserts that incumbent LECs should be required to consider the needs of collocators when remodeling or building new facilities.[1423] MFS and Teleport contend that incumbent LECs should not be able to limit the amount of space that may be occupied by an interconnector's equipment unless the incumbent LEC demonstrates that space is nearing exhaustion.[1424] MCI asserts that we should prohibit an incumbent LEC from denying a collocator use of available space unless the incumbent demonstrates that it had plans for such space prior to the request for collocation.[1425] In locations where space is scarce, MCI argues that incumbent LECs should be required to file reports with the FCC on the status and planned increase and use of space.[1426] Bell Atlantic counters that such a policy could prevent it from serving its customers efficiently.[1427] Pacific Telesis suggests that the Commission reiterate its policy of allowing "reasonable restrictions on warehousing of unused space by interconnectors."[1428] The Pennsylvania Commission asserts that it is not necessary for the FCC to adopt national guidelines regarding space allocation.[1429] GVNW argues that collocation should be required in rural areas only where there is space available.[1430]

(3). Discussion

585. We believe that incumbent LECs have the incentive and capability to impede competitive entry by minimizing the amount of space that is available for collocation by competitors. Accordingly, we adopt our *Expanded Interconnection* space allocation rules for purposes of section 251, except as indicated herein. LECs will thus be required to make space available to requesting carriers on a first-come, first-served basis. We also conclude

---

[1423] AT&T comments at 41-42 (where space is unavailable incumbent LECs should be required to provide trunking at no extra cost and enable the interconnector to connect to designated equipment elsewhere, with a timetable for moving the interconnector to the incumbent LEC's premises when space becomes available).

[1424] MFS comments at 34; Teleport comments at 33.

[1425] MCI comments at 56.

[1426] MCI comments at 56.

[1427] Bell Atlantic reply at 16.

[1428] PacTel comments at 36.

[1429] Pennsylvania Commission comments at 22.

[1430] GVNW comments at 8.

that collocators seeking to expand their collocated space should be allowed to use contiguous space where available. We further conclude that LECs should not be required to lease or construct additional space to provide physical collocation to interconnectors when existing space has been exhausted. We find such a requirement unnecessary because section 251(c)(6) allows incumbent LECs to provide virtual collocation where physical collocation is not practical for technical reasons or because of space limitations. Consistent with the requirements and findings of the *Expanded Interconnection* proceeding, we conclude that incumbent LECs should be required to take collocator demand into account when renovating existing facilities and constructing or leasing new facilities, just as they consider demand for other services when undertaking such projects. We find that this requirement is necessary in order to ensure that sufficient collocation space will be available in the future. We decline, however, to adopt a general rule requiring LECs to file reports on the status and planned increase and use of space. State commissions will determine whether sufficient space is available for physical collocation, and we conclude that they have authority under the 1996 Act to require incumbent LECs to file such reports. We expect individual state commissions to determine whether the filing of such reports is warranted.

586. We also agree with Pacific Telesis that restrictions on warehousing of space by interconnectors are appropriate.[1431] Because collocation space on incumbent LEC premises may be limited, inefficient use of space by one competitive entrant could deprive another entrant of the opportunity to collocate facilities or expand existing space. In the *Expanded Interconnection* proceeding, we allowed "reasonable restrictions on warehousing of space,"[1432] and will adopt this provision for purposes of section 251. As discussed below, we also adopt measures to ensure that incumbent LECs themselves do not unreasonably "warehouse" space, although we do permit them to reserve a limited amount of space for specific future uses.[1433] Incumbent LECs, however, are not permitted to set maximum space limitations without demonstrating that space constraints make such restrictions necessary, as such maximum limits could constrain a collocator's ability to provide service efficiently.

587. We also address the impact on small incumbent LECs. For example, GVNW argues that we should require collocation in rural areas only where there is space available. We have considered the impact of our rules in this section on small incumbent LECs and do not require physical collocation at any point where there is insufficient space available. We decline, however, to adopt rules regarding space availability that apply differently to small, rural carriers because the rules we here adopt are sufficiently flexible. We also note,

---

[1431] PacTel comments at 36.

[1432] *Special Access Order*, 7 FCC Rcd at 7408; *see also Remand Order*, 9 FCC Rcd at 187-88.

[1433] *See infra*, Section VI.B.1.i.

however, that section 251(f) of the 1996 Act provides relief to certain small LECs from our regulations implementing section 251.[1434]

f. Leasing Transport Facilities

(1). Background

588. Our *Expanded Interconnection* rules require LECs to provide collocation for the purpose of allowing collocators to terminate their own transmission facilities for special access or switched transport service.[1435] We did not require that collocation be made available for other purposes, for example, when the interconnecting party wished only to connect incumbent LEC transmission facilities to collocated equipment. We sought comment in the NPRM on whether we should modify the standards of the *Expanded Interconnection* proceeding in light of the new statutory requirements and disputes that have arisen in the investigations regarding the incumbent LECs' physical and virtual collocation tariffs.[1436]

(2). Comments

589. MCI and others argue that collocators should not be prohibited from leasing transport facilities from the incumbent LEC to connect equipment in the collocated space to any other point in the incumbent LEC's network.[1437] Pacific Telesis contends that LECs should not be required to permit collocation of equipment that will be connected to a LEC's transmission facilities because such a policy would result in exhaustion of central office space and is outside the purposes of the 1996 Act.[1438] Bell Atlantic argues that permitting such interconnection is not advisable, because it would allow resellers to obtain lower-priced interconnection and access to unbundled elements without providing any facilities of their own.[1439]

[1434] *See infra*, Section XII.

[1435] *See Remand Order*, 9 FCC Rcd at 5180-81, 5183; *Special Access Order*, 7 FCC Rcd at 7403; *Switched Transport Order*, 8 FCC Rcd at 7402.

[1436] NPRM at para. 73.

[1437] MCI comments at 55; ACTA comments at 16; Telecommunications Resellers Ass'n comments at 47.

[1438] PacTel comments at 39, reply at 14.

[1439] Bell Atlantic reply at 16.

(3). Discussion

590. Although in *Expanded Interconnection* the Commission required that interested parties interconnect collocated equipment with their own transmission facilities,[1440] we conclude that it would be inconsistent with the provisions of the 1996 Act to adopt that requirement under section 251. Rather, we conclude that a competitive entrant should not be required to bring transmission facilities to LEC premises in which it seeks to collocate facilities. Entrants should instead be permitted to collocate and connect equipment to unbundled network transmission elements obtained from the incumbent LEC. The purpose of the *Expanded Interconnection* requirement was to foster competition in the market for interstate switched and special access transmission facilities.[1441] The purposes of section 251 are broader. Section 251(c)(3) requires that competitive entrants be given access to unbundled elements and that they be permitted to combine such elements.[1442] Prohibiting competitors from connecting unbundled network elements to their collocated equipment would appear contrary to the provisions of section 251(c)(3).

591. Finally, we find that Bell Atlantic's opposition to this requirement is without merit. Bell Atlantic argues that collocators should be required to provide their own transmission facilities because otherwise new entrants could compete without providing any of their own facilities. Section 251(c)(3) specifically states that unbundled elements are to be provided in a manner that allows requesting carriers to combine elements in order to provide telecommunications service. As stated above, requiring collocators to supply their own transmission facilities would amount to a prohibition on connecting unbundled transmission facilities to other unbundled elements connected to equipment in the collocation space. Although such interconnection arrangements were not required by our *Expanded Interconnection* requirements, we conclude that they are required by section 251 when collocated equipment is used to achieve interconnection or access to unbundled network elements.

g. Co-Carrier Cross-Connect

(1). Background

592. In the most common collocation configuration under existing requirements, the designated physical collocation space of several competitive entrants is located close together

---

[1440] *Special Access Order*, 7 FCC Rcd at 7403; *Switched Transport Order*, 8 FCC Rcd at 7402.

[1441] *See Special Access Order*, 7 FCC Rcd at 7372; *Switched Transport Order*, 8 FCC Rcd at 7377.

[1442] 47 U.S.C. 251(c)(3).

within the LEC premises. Since carriers connect to the collocation space via high-capacity lines, different competitive entrants seeking to interconnect with each other may find connecting between their respective collocation spaces on the LEC premises the most efficient means of interconnecting with each other. We sought comment in the NPRM on whether we should adopt any requirements in addition to those adopted in the *Expanded Interconnection* proceeding in order to fulfill the mandate of the 1996 Act.[1443]

(2). Comments

593. Several CAPs and IXCs argue that we should adopt as an additional requirement that interconnectors be allowed to connect directly to other collocators located at the collocation space.[1444] Incumbent LECs generally object to such a configuration on the basis that such access is not expressly required by the statute and that we therefore lack authority to impose such a requirement.[1445]

(3). Discussion

594. We believe that it serves the public interest and is consistent with the policy goals of section 251 to require that incumbents permit two or more collocators to interconnect their networks at the incumbent's premises. Parties opposed to this proposal have offered no legitimate objection to such interconnection. Allowing incumbent LECs to prohibit collocating carriers from interconnecting their collocated equipment would require them to interconnect collocated facilities by routing transmission facilities outside of the LECs' premises. We find that such a policy would needlessly burden collocating carriers. To the extent equipment is collocated for the purposes expressly permitted under section 251(c)(6), the statute does not bar us from requiring that incumbent LECs allow connection of such equipment to other collocating carriers located nearby. We find that requiring LECs to allow such interconnection of collocated equipment will foster competition by promoting efficient operation. It is also unlikely to have a significant effect on space availability. We find authority for such a requirement in section 251(c)(6), which requires that collocation be provided on "terms and conditions that are just, reasonable, and nondiscriminatory" and in section 4(i), which permits the Commission to "perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this Act, as may be necessary in the

[1443] NPRM at para. 73.

[1444] *See, e.g.*, MCI comments at 55; MFS comments at 24; GGI comments at 10; Telecommunications Resellers Ass'n comments at 47; Intermedia comments at 9.

[1445] *See, e.g.*, GTE reply at 15; Bell Atlantic reply at 15; PacTel reply at 14; Sprint reply at 23.

execution of its functions."[1446] We therefore will require that incumbent LECs allow collocating telecommunications carriers to connect collocated equipment to such equipment of other carriers within the same LEC premises so long as the collocated equipment is used for interconnection with the incumbent LEC or access to the LEC's unbundled network elements.

595. We clarify that we here require incumbent LECs to provide the connection between the equipment in the collocated spaces of two or more collocating telecommunications carriers unless they permit the collocating parties to provide this connection for themselves. We do not require incumbent LECs to allow placement of connecting transmission facilities owned by competitors within the incumbent LEC premises anywhere outside of the actual physical collocation space.

h. Security Arrangements

(1). Background

596. Under our *Expanded Interconnection* requirements, incumbent LECs typically require that physically collocated equipment be placed inside a collocation cage within the incumbent LEC facility. Such cages are intended to separate physically the competitors' facilities from those of the incumbent and to prevent access by unauthorized personnel to any parties' equipment. Such cages frequently add considerably to the cost of establishing physical collocation at a particular LEC premises and could constitute a barrier to entry in certain circumstances.

(2). Comments

597. Teleport argues that cage construction is one of the most expensive items associated with physical collocation and that we should modify our *Expanded Interconnection* requirements to allow new entrants to subcontract construction of their physical collocation security arrangements with contractors approved by the incumbent LEC.[1447] ALTS and MCI argue that security measures should only be provided at the request of the entrant and at the cost the entrant would have incurred if it performed the construction itself.[1448] GVNW

[1446] 47 U.S.C. § 154(i).

[1447] Teleport comments at 32.

[1448] ALTS comments at 23; MCI comments at 58; *contra* PacTel reply at 15.

argues that incumbent LECs need to ensure that a competitor's personnel do not cause breaches of security and therefore should be subject to minimum proficiency requirements.[1449]

(3). Discussion

598. Based on the comments in this proceeding and our previous experience with physical collocation in the *Expanded Interconnection* docket, we will continue to permit LECs to require reasonable security arrangements to separate an entrant's collocation space from the incumbent LEC's facilities. The physical security arrangements around the collocation space protect both the LEC's and competitor's equipment from interference by unauthorized parties. We reject the suggestion of ALTS and MCI that security measures be provided only at the request of the entrant since LECs have legitimate security concerns about having competitors' personnel on their premises as well. We conclude that the physical separation provided by the collocation cage adequately addresses these concerns. At the same time, we recognize that the construction costs of physical security arrangements could serve as a significant barrier to entry, particularly for smaller competitors. We also conclude that LECs have both an incentive and the capability to impose higher construction costs than the new entrant might need to incur. We therefore conclude that collocating parties should have the right to subcontract the construction of the physical collocation arrangements with contractors approved by the incumbent LEC. Incumbent LECs shall not unreasonably withhold such approval of contractors. Approval by incumbent LECs of such contractors should be based on the same criteria as such LECs use for approving contractors for their own purposes. We decline, however, to require that competitive entrants' personnel be subject to minimum training and proficiency requirements as suggested by GVNW. We find that such concerns are better resolved through negotiation and arbitration.

i. Allowing Virtual Collocation in Lieu of Physical

(1). Background

599. Section 251(c)(6) requires that incumbent LECs provide physical collocation unless the carrier "demonstrates to the state commission that physical collocation is not practical for technical reasons or because of space limitations . . . ."[1450] In the NPRM, we sought comment on whether the Commission should establish guidelines for states to apply

[1449] GVNW comments at 10; *accord* Rural Tel. Coalition comments at 31.

[1450] 47 U.S.C.§ 251(c)(6).

when determining whether physical collocation is not practical for "technical reasons or because of space limitations."[1451]

(2). Comments

600. Pacific Telesis argues that national standards to determine whether physical collocation is not practical at a specific LEC location are unnecessary. It further argues that "reduced reliability or other harm to the network" should be considered a technical reason that justifies refusal to allow physical collocation.[1452] IXCs and CAPs assert that the burden of showing that physical collocation is not practical should fall on the incumbent LEC.[1453] AT&T contends that an incumbent LEC should be required to show that there is no practical way of providing additional space before it is relieved of its obligation to provide physical collocation. If physical collocation is genuinely not practical, then AT&T argues that the incumbent should provide trunking at no cost to allow the entrant to interconnect.[1454] Time Warner asserts that, where physical collocation is not possible in a LEC central office, LECs should supply a substitute at cost.[1455] State commissions that comment on this issue generally oppose strict national rules and argue that, to the extent such rules are adopted, they should allow the states maximum flexibility.[1456]

601. Time Warner also asserts that the FCC should require LECs to offer a $1 sale and repurchase option for virtually collocated equipment.[1457] The Independent Cable and Telecommunications Association argues that incumbent LECs should be required to provide virtual collocation that is equal in all functional aspects to physical collocation in order to

[1451] NPRM para. 72.

[1452] PacTel comments at 39.

[1453] *See, e.g.*, Hyperion comments at 14; ACSI comments at 16; AT&T comments at 41.

[1454] AT&T comments at 41-42.

[1455] Time Warner comments at 36, 40.

[1456] *See, e.g.*, Texas Commission comments at 14; Pennsylvania Commission comments at 22; Oregon Commission comments at 23.

[1457] Time Warner comments at 38.

avoid prejudicing small entities that may not have sufficient market share to justify a physical collocation arrangement.[1458]

(3). Discussion

602. Section 251(c)(6) clearly contemplates the provision of virtual collocation when physical collocation is not practical for technical reasons or because of space limitations.[1459] Section 251(c)(6) requires the incumbent LEC to demonstrate to the state commission's satisfaction that there are space limitations on the LEC premises or that technical considerations make collocation impractical. Because the space limitations and technical practicality issues will vary considerably depending on the location at which competitor equipment is to be collocated, we find that these issues are best handled on a case-by-case basis, as they were under our *Expanded Interconnection* requirements.[1460] In light of our experience in the *Expanded Interconnection* proceeding, we require that incumbent LECs provide the state commission with detailed floor plans or diagrams of any premises where the incumbent alleges that there are space constraints. Submission of floor plans will enable state commissions to evaluate whether a refusal to allow physical collocation on the grounds of space constraints is justified. We also find that the approach detailed by AT&T in its July 12 *Ex Parte* submission to be useful and believe that state commissions may find it a valuable guide.[1461]

603. Although section 251(c)(6) provides that incumbent LECs are not required to provide physical collocation where impractical for technical reasons or because of space limitations, our experience in the *Expanded Interconnection* proceeding has not demonstrated that technical reasons, apart from those related to space availability, are a significant impediment to physical collocation. We therefore decline to adopt any rules for determining when physical collocation should be deemed impractical for technical reasons.

604. Incumbent LECs are allowed to retain a limited amount of floor space for defined future uses. Allowing competitive entrants to claim space that incumbent LECs had

---

[1458] ICTA reply at 13.

[1459] 47 U.S.C § 251(c)(6).

[1460] *See Special Access Order*, 7 FCC Rcd 7407.

[1461] AT&T describes a detailed proposed showing that would be required of an incumbent LEC that claims physical collocation is not practical because of space exhaustion. The proposed showing would require the specific identification of the space on incumbent LEC premises that is used for various purposes, as well as specific plans for rearrangement/expansion and identification of steps taken to avoid exhaustion. AT&T July 12, 1996 *Ex Parte*.

specifically planned to use could prevent incumbent LECs from serving their customers effectively.[1462] Incumbent LECs may not, however, reserve space for future use on terms more favorable than those that apply to other telecommunications carriers seeking to hold collocation space for their own future use.[1463]

605. We decline to adopt AT&T's suggestion that incumbent LECs should be required to lease additional space or provide trunking at no cost where they have insufficient space for physical collocation.[1464] In light of the availability of substitute virtual collocation arrangements, we find that requiring the type of "substitute" for physical collocation as advocated by AT&T is unnecessary. We similarly reject Time Warner's suggestion that incumbent LECs supply a "substitute" for physical collocation at cost, except to the extent we require virtual collocation. On the other hand, we will require incumbent LECs with limited space availability to take into account the demands of interconnectors when planning renovations and leasing or constructing new premises, as we have in the *Expanded Interconnection* proceeding.[1465]

606. Incumbent LECs are not required to provide collocation at locations where it is not technically feasible to provide virtual collocation. Although space constraints are a concern normally associated with physical collocation, given our broad reading of the term "premises,"[1466] we find that space constraints could preclude virtual collocation at certain LEC premises as well. State commissions will decide whether virtual collocation is technically feasible at a given point. We do, however, require that incumbent LECs relinquish any space held for future use before denying virtual collocation due to a lack of space unless the incumbent can prove to a state commission that virtual collocation at that point is not technically feasible. Moreover, when virtual collocation is not feasible, we require that incumbent LECs provide other forms of interconnection and access to unbundled network elements to the extent technically feasible.[1467]

[1462] *Special Access Order*, 7 FCC Rcd at 7409.

[1463] *See supra*, Section VI.B.1.e.

[1464] *See* AT&T comments at 41-42.

[1465] *See Special Access Order*, 7 FCC Rcd at 7408.

[1466] *See supra*, Section VI.B.1.c.

[1467] *See supra*, Section VI.A.

607. Finally, we decline to require that incumbent LECs provide virtual collocation that is equal in all functional aspects to physical collocation. Our *Expanded Interconnection* rules required a variety of standards for the virtual collocation and have been largely successful. In addition, Congress was aware of the differences between virtual and physical collocation when it adopted section 251(c)(6), and this section does not specify any requirements for virtual collocation.[1468] As discussed above, we adopt the *Expanded Interconnection* requirements for virtual collocation under section 251.[1469] We find, however, that a standard simply requiring equality in all functional aspects could be difficult to administrate and could lead to substantial disputes. We also decline to adopt the suggestion that we require LECs to offer virtual collocation under the "$1 sale and repurchase option."[1470] We do not find evidence that such a specific requirement is necessary at this time. We reserve the right to revisit these issues in the future, however, if we perceive that smaller entities would be disadvantaged by our existing standards.

2. Legal Issues

a. Relationship between *Expanded Interconnection* Tariffs and Section 251

(1). Background

608. The enactment of sections 251 and 252 raises the question of whether, and to what extent, the interconnection, access to unbundled network element, and collocation requirements set forth in those sections, and the delegation of specific rate-setting authority to the states under section 252(d)(1), as a matter of law supplant our section 201 *Expanded Interconnection* requirements. We tentatively concluded in the NPRM that our existing *Expanded Interconnection* policies for interstate special access and switched transport should continue to apply.[1471]

(2). Comments

[1468] *See Remand Order*, 9 FCC Rcd at 5166-69.

[1469] *See supra*, Section VI.B.1.a.

[1470] This configuration is described as involving "the acquisition by the interconnectors of the equipment to be dedicated for interconnectors' use on the LEC premises and the sale of that equipment to the LECs for a nominal $1 sum while maintaining a repurchase option." Time Warner comments at 42.

[1471] NPRM at para. 73.

609. Although commenting parties have not addressed this question directly, some commenters appear to assume that LECs will be required to continue to tariff their collocation offerings with the FCC, as currently required under *Expanded Interconnection*.[1472] Other parties appear to assume that requirements to file federal tariffs are inconsistent with, and superseded by, the negotiation and arbitration provisions in section 252.

(3). Discussion

610. Our *Expanded Interconnection* rules require the largest incumbent LECs to file tariffs with the Commission to offer collocation to parties that wish to terminate interstate special access and switched transport transmission facilities. Section 252 of the 1996 Act, on the other hand, provides for interconnection arrangements rather than tariffs, for review and approval of such agreements by state commissions rather than the FCC, and for public filing of such agreements. Section 252 procedures, however, apply only to "request[s] for interconnection, services, or network elements *pursuant to section 251*."[1473] Such procedures do not, by their terms, apply to requests for service under section 201. Moreover, section 251(i) expressly provides that "[n]othing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201,"[1474] which provided the statutory basis for our *Expanded Interconnection* rules. Thus, we find that the 1996 Act, as a matter of law, does not displace our *Expanded Interconnection* requirements, and, in fact, grants discretion to the FCC to preserve our existing rules and tariffing requirements to the extent they are consistent with the Communications Act.

611. We further conclude that it would make little sense to find that sections 251 and 252 supersede our *Expanded Interconnection* rules, because the two sets of requirements are not coextensive. For example, our *Expanded Interconnection* rules encompass collocation for interstate purposes for all parties, including non-carrier end users, that seek to terminate transmission facilities at LEC central offices.[1475] In comparison, section 251 requires collocation only for "any requesting telecommunications carrier."[1476] Certain competing carriers -- and non-carrier customers not covered by section 251 -- may prefer to take

[1472] *See, e.g.*, MFS comments at 32; MCI comments at 58.

47 U.S.C § 252(a)(1) (emphasis added).

Section 201 authorizes the Commission "to establish physical connections with other carriers . . ." 47 U.S.C. 1.

pecial Access Order, 7 FCC Rcd at 7403.

e 47 U.S.C. § 251(c)(2) and (3).

interstate expanded interconnection service under general interstate tariff schedules. We find that it would be unnecessarily disruptive to eliminate that possibility at this time. We also conclude that permitting requesting carriers to seek interconnection pursuant to our *Expanded Interconnection* rules as well as section 251 is consistent with the goals of the 1996 Act to permit competitive entry through a variety of entry strategies. Thus, a requesting carrier would have the choice of negotiating an interconnection agreement pursuant to sections 251 and 252 or of taking tariffed interstate service under our *Expanded Interconnection* rules.

612. Finally, we expect that, over time, sections 251 and 252 and our implementing rules may replace our *Expanded Interconnection* rules as the primary regulations governing interconnection for carriers. We note that section 251 is broader than our *Expanded Interconnection* requirements in certain respects. For example, section 251 requires incumbent LECs to offer collocation for purposes of accessing unbundled network elements, whereas our *Expanded Interconnection* rules require collocation only for the provision of interstate special access and switched transport.[1477] In addition, section 251(c)(6) requires incumbents to offer physical collocation subject to certain exceptions, whereas our existing *Expanded Interconnection* rules only require carriers to offer virtual collocation, although they may choose to offer physical collocation under Title II regulation in lieu of virtual collocation. In the future, we may review the need for a separate set of *Expanded Interconnection* requirements and revise our requirements if necessary. We believe that this approach is consistent with Congress' determination that the need for federal regulations will likely decrease as the provisions of the 1996 Act take effect and competition develops in the local exchange and exchange access markets.[1478]

b. Takings Issues

(1). Background

613. In *Bell Atlantic v. FCC*, the U.S. Court of Appeals for the D.C. Circuit found that the Commission lacked authority under the Communications Act to impose physical collocation on the LECs. The court found that this requirement implicated the Fifth Amendment takings clause.[1479] On remand, the Commission required LECs to provide virtual

[1477] *See Special Access Order*, 7 FCC Rcd 7369; *Switched Transport Order*, 8 FCC Rcd 7372.

[1478] *See, e.g.*, 47 U.S.C. § 161 (requiring the Commission to "review all regulations . . . in effect at the time of the review that apply to the operations or activities of any provider of telecommunications service.").

[1479] *See Bell Atlantic v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994).

collocation. In *Pacific Bell v. FCC*,[1480] several LECs challenged the Commission's virtual collocation rules on essentially identical grounds, claiming that the virtual collocation rules also constituted an unauthorized taking. The court did not reach the merits of these claims. Instead, addressing the scope of section 251 immediately following enactment and before the FCC had yet exercised its interpretive authority with respect to the provision, the court stated that regulations enacted to implement the 1996 Act would render moot questions regarding the future effect of the virtual collocation order under review. The court did not vacate the order, but remanded to the Commission the issues presented in that case.[1481]

(2). Comments

614. U S West and BellSouth argue that virtual collocation is a taking and that the Commission lacks authority under section 201 to require virtual collocation under its *Expanded Interconnection* rules.[1482] U S West also argues that the Commission lacks authority to require virtual collocation under section 251.[1483] Some incumbent LECs and the Florida Commission also argue that physical collocation amounts to a taking in violation of the Fifth Amendment.[1484] In opposition, several competitive carriers argue that rates that recover incremental costs of collocation will satisfy constitutional "just compensation concerns."[1485]

(3). Discussion

615. We conclude that the ruling in *Bell Atlantic* does not preclude the rules we are adopting in this proceeding. The court in *Bell Atlantic* did not hold that an agency may never "take" property; the court acknowledged that, as a constitutional matter, takings are unlawful

[1480] 81 F.3d 1147 (D.C. Cir. 1996).

[1481] *Id.*

[1482] U S West comments at 29-30; BellSouth comments at 25.

[1483] U S West comments at 30.

[1484] ALLTEL comments at 9; GTE comments at 66-68; US West comments at 29-31; Florida Commission comments at 15 (readoption of old physical collocation rules would be invalidated as a taking but should be readopted as model rules for the states to adopt if they chose).

[1485] MFS reply at 23; ACSI reply at 8-9; GST reply 14; ALTS reply at 8-11.

only if they are not accompanied by "just compensation."[1486] Instead, the court simply said that the Communications Act of 1934 should not be construed to permit the FCC to take LEC property without *express* authorization. Because the court concluded that mandatory physical collocation would likely constitute a taking,[1487] and that section 201 of the Act did not expressly authorize physical collocation, the court held that the Commission was without authority under section 201 to impose physical collocation requirements on LECs.[1488]

616. The question of statutory authority to impose (physical or virtual) collocation obligations on incumbent LECs largely evaporates in the context of the 1996 Act. New section 251(c)(6) *expressly* requires incumbent LECs to provide physical collocation, absent space or technical limitations. Where such limitations exist, the statute *expressly* requires virtual collocation. Thus, under the court's analysis in *Bell Atlantic*, there is no warrant for a narrowing construction of section 251 that would deny us the authority to require either form of collocation. Moreover, for the reasons stated in the *Virtual Collocation Order*,[1489] we continue to believe that virtual collocation, as we have defined it, is not a taking, and that our authority to order such collocation (under either section 251 or section 201) is not subject to the strict construction canon announced in *Bell Atlantic*.

617. Given that we now have express statutory authority to order physical and virtual collocation pursuant to section 251, any remaining takings-related issue necessarily is limited to the question of just compensation. As discussed in Section VII.B.2.a.(3).(c), below, we find that the ratemaking methodology we are adopting to implement the collocation obligations under section 251(c) is consistent with congressional intent and fully satisfies the just compensation standard. There is, therefore, no merit to the LECs' Fifth Amendment-based claims.

[1486] *Bell Atlantic*, 24 F.3d at 1445.

[1487] The Commission maintains the position that mandatory physical collocation should not properly be seen to create a takings issue. *See Remand Order*, 9 FCC Rcd at 5169.

[1488] *See Bell Atlantic*, 24 F.3d at 1447 ("we hold that the Act does not expressly authorize an order of physical co-location and thus the Commission may not impose it.").

[1489] *See* 9 FCC Rcd at 5161-66.

VII. PRICING OF INTERCONNECTION AND UNBUNDLED ELEMENTS

A. Overview

618. The prices of interconnection and unbundled elements, along with prices of resale and transport and termination, are critical terms and conditions of any interconnection agreement. If carriers can agree on such prices voluntarily without government intervention, these agreements will be submitted directly to the states for approval under section 252. To the extent that the carriers, in voluntary negotiations, cannot determine the prices, state commissions will have to set those prices. The price levels set by state commissions will determine whether the 1996 Act is implemented in a manner that is *pro-competitor* and favors one party (whether favoring incumbents or entrants) or, as we believe Congress intended, *pro-competition*. As discussed more fully in Section II.D. above, it is therefore critical to implementing Congress's pro-competitive, de-regulatory national policy framework to establish among the states a common, pro-competition understanding of the pricing standards for interconnection and unbundled elements, resale, and transport and termination. While such a common interpretation might eventually emerge through judicial review of state arbitration decisions, we believe that such a process could delay competition for years and require carriers to incur substantial legal costs.[1490] We therefore conclude that, to expedite the development of fair and efficient competition, we must set forth rules now establishing this common, pro-competition understanding of the 1996 Act's pricing standards. Accordingly, the rules we adopt today set forth the methodological principles for states to use in setting prices. This section addresses interconnection and unbundled elements, and subsequent sections address resale and transport and termination, respectively.

619. While every state should, to the maximum extent feasible, immediately apply the pricing methodology for interconnection and unbundled elements that we set forth below, we recognize that not every state will have the resources to implement this pricing methodology immediately in the arbitrations that will need to be decided this fall. Therefore, so that competition is not impaired in the interim, we establish default proxies that a state commission shall use to resolve arbitrations in the period before it applies the pricing methodology. In most cases, these default proxies for unbundled elements and interconnection are ceilings, and states may select lower prices. In one instance, the default proxy we establish is a price range. Once a state sets prices according to an economic cost study conducted pursuant to the cost-based pricing methodology we outline, the defaults cease to apply. In setting a rate pursuant to the cost-based pricing methodology, and especially when setting a rate above a default proxy ceiling or outside the default proxy range, the state must give full and fair effect to the economic costing methodology we set forth in this Order and must create a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate.

[1490] For a discussion of our legal authority to adopt national pricing rules, *see supra*, Section II.D.

620. In the following sections, we first set forth generally, based on the current record, a cost-based pricing methodology based on forward-looking economic costs, which we conclude is the approach for setting prices that best furthers the goals of the 1996 Act. In dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs. If market prices exceed forward-looking economic costs, new competitors will enter the market. If their forward-looking economic costs exceed market prices, new competitors will not enter the market and existing competitors may decide to leave. Prices for unbundled elements under section 251 must be based on cost under the law, and that should be read as requiring that prices be based on forward-looking economic costs. New entrants should make their decisions whether to purchase unbundled elements or to build their own facilities based on the relative economic costs of these options. By contrast, because the cost of building an element is based on forward-looking economic costs, new entrants' investment decisions would be distorted if the price of unbundled elements were based on embedded costs. In arbitrations of interconnection arrangements, or in rulemakings the results of which will be applied in arbitrations, states must set prices for interconnection and unbundled network elements based on the forward-looking, long-run, incremental cost methodology we describe below. Using this methodology, states may not set prices lower than the forward-looking incremental costs directly attributable to provision of a given element. They may set prices to permit recovery of a reasonable share of forward-looking joint and common costs of network elements.[1491] In the aftermath of the arbitrations and relying on the state experience, we will continue to review this costing methodology, and issue additional guidance as necessary.

621. We reject various arguments raised by parties regarding the recovery of costs other than forward-looking economic costs in section 251(c)(2) and (c)(3) prices, including the possible recovery of: (1) embedded or accounting costs in excess of economic costs; (2) incumbent LECs' opportunity costs; (3) universal service subsidies; and (4) access charges. As discussed in Section VII.B.2.a. below, certain portions of access charges may continue to be collected for an interim period in addition to section 251(c)(3) prices.

622. With respect to prices developed under the forward-looking, cost-based pricing methodology, we conclude that incumbent LECs' rates for interconnection and unbundled elements must recover costs in a manner that reflects the way they are incurred. We adopt certain rules that states must follow in setting rates in arbitrations. These rules are designed to ensure the efficient cost-based rates required by the 1996 Act.

623. In the next section of the Order, we establish default proxies that states may elect to use prior to utilizing an economic study and developing prices using the cost-based pricing methodology. We recognize that certain states may find it difficult to apply an

[1491] We define these and other forward-looking cost concepts *infra*, Section VII.B.2.a. We define what we consider to be a reasonable share of forward-looking joint and common costs *infra*, Section VII.B.2.a.

economic costing methodology within the statutory time frame for arbitrating interconnection disputes. We therefore set forth default proxies that will be relatively easy to apply on an interim basis to interconnection arrangements. We discuss with respect to particular unbundled elements the reasonable rate structure for those elements and the particular default proxies we are establishing for use pending our adoption of a generic forward-looking cost model. Finally, we discuss the following additional matters: generic forward-looking costing models that we intend to examine further by the first quarter of 1997 in order to determine whether any of those models, with modifications, could serve as better default proxies; the future adjustment of rates; the relationship of unbundled element prices to retail prices; and the meaning of the statutory prohibition against discrimination in sections 251 and 252.

624. Those states that have already established methodologies for setting interconnection and unbundled rates must review those methodologies against the rules we are adopting in this Order. To the extent a state's methodology is consistent with the approach we set forth herein, the state may apply that methodology in any section 252 arbitration. However, if a state's methodology is not consistent with the rules we adopt today, the state must modify its approach. We invite any state uncertain about whether its approach complies with this Order to seek a declaratory ruling from the Commission.

B. Cost-Based Pricing Methodology

625. As discussed more fully in Section II.D. above, although the states have the crucial role of setting specific rates in arbitrations, the Commission must establish a set of national pricing principles in order to implement Congress's national policy framework. For the reasons set forth in the preceding section and as more fully explained below, we are adopting a cost-based methodology for states to follow in setting interconnection and unbundled element rates. In setting forth the cost-based pricing methodology for interconnection and access to unbundled elements, there are three basic sets of questions that must be addressed. First, does the 1996 Act require that the same standard apply to the pricing of interconnection provided pursuant to section 251(c)(2), and unbundled elements provided pursuant to section 251(c)(3)? Second, what is the appropriate methodology for establishing the price levels for interconnection and for each unbundled element, how should costs be defined, and is the price based on economic costs, embedded costs, or other costs? Third, what are the appropriate rate structures to be used to set prices designed to recover costs, including a reasonable profit? We address each of these questions in the following sections.

1. Application of the Statutory Pricing Standard

a. Background

626. In the NPRM, we proposed that any pricing principles we adopt should be the same for interconnection and unbundled network elements because sections 251(c)(2) and (c)(3) and 252(d)(1) use the same pricing standard.[1492] We invited parties to comment on this issue and to justify any proposed distinction in the pricing for interconnection and unbundled network elements. We also stated our belief that the same pricing rules that apply to interconnection and unbundled network elements should also apply to collocation under section 251(c)(6) of the 1996 Act.

b. Comments

627. Commenters generally agree that any pricing rules adopted by the Commission for interconnection and unbundled elements should be the same.[1493] These parties assert that any pricing rules the Commission ultimately adopts should not, therefore, create incentives to substitute or arbitrage one type of classification for another. Commenters also generally agree that the pricing rules the Commission adopts for interconnection and unbundled elements should also apply to collocation.[1494] Many of these parties agree that collocation is a subset of the interconnection arrangements contemplated by sections 251(c)(2) and 252(d)(1).[1495] On the other hand, a few parties contend that the pricing standards contained in section 252(d)(1) for interconnection and unbundled elements do not apply to collocation provided under section 251(c)(6).[1496] BellSouth argues that the Commission should not adopt any national standards for virtual collocation.[1497] Other commenters, including some that oppose the establishment of

---

[1492] NPRM at para. 122.

[1493] *See, e.g.*, Citizens Utilities comments at 16 n.14; Ohio Commission comments at 42; Teleport comments at 46.

[1494] *E.g.*, ACSI comments at 16; ALTS comments at 34-35; Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MCI comments at 54, 61; MFS comments at 30; NEXTLINK comments at 26; PacTel comments at 63; Sprint comments at 42; Teleport comments at 46.

[1495] *See, e.g.*, Citizens Utilities comments at 16 n.14; Colorado Commission comments at 34; MFS comments at 30; NEXTLINK comments at 26.

[1496] *See, e.g.*, SNET comments at 24 n.44.

[1497] BellSouth comments at 23.

pricing rules by the Commission, argue that, to the extent that the Commission adopts national standards for collocation, they should generally follow those established in the Commission's *Expanded Interconnection* proceeding in CC Docket No. 91-141.[1498]

c. Discussion

628. Sections 251(c)(2) and (c)(3) impose an identical duty on incumbent LECs to provide interconnection and access to network elements "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory."[1499] In addition, both interconnection and unbundled network elements are made subject to the same pricing standard in section 252(d)(1). Based on the plain language of sections 251(c)(2), (c)(3), and section 252(d)(1), we conclude that Congress intended to apply the same pricing rules to interconnection and unbundled network elements. The pricing rules we adopt shall, therefore, apply to both.

629. We further conclude that, because section 251(c)(6) requires that incumbent LECs provide physical collocation on "rates, terms, and conditions that are just, reasonable, and nondiscriminatory," which is identical to the standard for interconnection and unbundled elements in sections 251(c)(2) and (c)(3), collocation should be subject to the same pricing rules.[1500] We also note that, because collocation is a method of obtaining interconnection and access to unbundled network elements, collocation is properly treated under the same pricing rules. This legal conclusion that there should be a single set of pricing rules for interconnection, unbundled network elements, and collocation provides greater consistency and guidance to the industry, regulators, and the courts. Moreover, it reduces the regulatory burdens on state commissions of developing and applying different pricing rules for collocation, interconnection, and unbundled network elements. We note that our adoption of this single set of pricing rules should minimize regulatory burdens, conflicts, and uncertainties associated with multiple, and possibly inconsistent rules, thus facilitating competition on a reasonable and efficient basis minimizing the economic impact of our rules for all parties, including small entities and small incumbent LECs.[1501]

[1498] *See, e.g.*, Bell Atlantic comments at 32-34.

[1499] 47 U.S.C. § 251(c)(2), (c)(3).

[1500] *See supra*, Section VI.B.

[1501] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

2. Rate Levels

a. Pricing Based on Economic Cost

(1) Background

630. We observed in the NPRM that economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.[1502] We noted, however, that there was a lack of general agreement on the specifics of methodology for deriving prices based on LRIC or total service long-run incremental cost (TSLRIC). We invited parties to comment on whether we should require the states to employ a LRIC-based pricing methodology and to explain with specificity the costing methodology they support.[1503] We recognized, however, that prices based on LRIC might not permit recovery of forward-looking costs if there were significant forward-looking joint and common costs among network elements.[1504] We sought comment on how, if rates are set above incremental cost, to deal with the problems inherent in allocating common costs and any other overheads.[1505] We observed that, by defining the unbundled elements at a sufficiently aggregated level, it may be possible to reduce the costs to be allocated as joint and common by identifying a substantial portion of costs as incremental to a particular element. To the extent that joint and common costs cannot be entirely eliminated, we sought comment on various methodologies for assigning them, including the use of a fixed allocator or on the basis of inverse demand elasticity. We also sought comment on whether, regardless of the method of allocating common costs, we should limit rates to levels that do not exceed stand-alone costs.[1506] Finally, we invited parties to comment on whether a LRIC-based methodology would establish a price for interconnection and unbundled network elements that includes a reasonable profit and thus complies with section 252(d)(1).[1507]

631. A number of states already employ, or have plans to utilize, some form of LRIC

[1502] NPRM at para. 124.

[1503] *Id.* at para. 126.

[1504] *Id.* at para. 129.

[1505] *Id.* at para. 130.

[1506] *Id.* For a definition of stand-alone costs, *see* Section VII.B.2.a. *infra*.

[1507] 47 U.S.C. § 252(d)(1)(A)(i); NPRM at para. 129.

or TSLRIC methodology in their approach to setting prices for unbundled network elements,[1508] with several states choosing LRIC or TSLRIC as a price floor.[1509] For instance, the Connecticut Commission adopted a TSLRIC methodology to measure the cost of service of SNET, its principal incumbent LEC.[1510] Arizona also requires incumbent LECs to conduct TSLRIC cost studies to establish the underlying cost of unbundled services and facilities.[1511] The Ohio Commission has adopted Long Run Service Incremental Cost ("LRSIC"), which is closely related to TSLRIC.[1512] The Missouri and Wyoming Commissions are among a number of state commissions that have not yet adopted a pricing methodology, but are considering LRIC or TSLRIC.[1513] Oklahoma law provides for submission of LRIC cost studies and studies identifying a contribution to common costs for interconnection of facilities and access to network elements to the Oklahoma Commission during an arbitration.[1514] A number of

[1508] *See, e.g.*, California Commission comments at 29 (California has adopted TSLRIC as the standard for developing the costs of unbundled elements and in a rulemaking this summer will determine the unbundled network elements and what level of shared and common costs should be included in the price of each); Michigan Commission comments at 13 (1996 prices for loops to remain at levels established by the Michigan Commission in its original interconnection order or at TSLRIC); Texas Commission comments at 22 (Texas Commission has employed LRIC-based pricing methodologies for many years; SWBT and GTE required to file LRIC cost studies to be used in pricing not later than November 1, 1996).

[1509] *See, e.g.*, Colorado Commission comments at Attachment (Rules Prescribing Principles for Costing and Pricing of Regulated Services of Telecommunications Service Providers) 4 CCR 723-30, Rules 4-5; Hawaii Administrative Rules, Sections 6-80-32-34 (setting out a three-tiered pricing regime with TSLRIC set as floor for pricing of competitive services); Louisiana Commission comments at Attachment (Louisiana Public Service Commission "Regulations for Competition in the Local Telecommunications Market"), p.30; Washington Commission comments at 25, Appendix B (*Washington Utilities and Transportation Commission v. U S West Communications*, Docket No. UT-950200 at 82 (Washington Commission, April 11, 1996)); Wisconsin Stat. Ann. section 196.204 (requiring the price of each network service or function to exceed TSLRIC).

[1510] Connecticut Commission comments at 4.

[1511] Arizona Commission comments, Exhibit V (Arizona Administrative Code R14-2-1101 *et seq.*), p.10.

[1512] *See* Ohio Commission comments at 43-45.

[1513] *See, e.g.*, Missouri Commission comments at 11 (supports LRIC for costing; LRIC is defined in pending state legislation); Wyoming Commission comments at 26-27 (draft rules propose use of TSLRIC as a price floor, with prices to include a contribution to shared, common, and joint costs, and the sum of prices for unbundled elements not to exceed retail for bundled services; incumbent LECs shall impute the prices of unbundled elements into the price floors of each of their own services that utilize the network elements).

[1514] Oklahoma Commission comments at Appendix A (Corporation Commission Telephone Rules OAC 165:55-17-25), pp.10-11.

states have yet to choose a pricing methodology. For instance, the New York Commission sets prices on a case-by-case basis.[1515] Unbundled element prices also exist in several states pursuant to negotiated interconnection agreements that have either already been approved by state commissions or are under consideration.[1516]

632. Section 252(d)(1) requires, *inter alia*, that rates for interconnection and unbundled network elements be based on "cost (determined without reference to a rate-of-return or other rate-based proceeding)."[1517] We tentatively concluded in the NPRM that this language precludes states from setting rates by use of traditional cost-of service regulation, with its detailed examination of historical carrier investment and expenses.[1518] Instead, we indicated our belief that the statute contemplates the use of other forms of cost-based price regulation, such as the setting of prices based on forward-looking economic cost methodologies (such as LRIC) that do not involve the use of an embedded rate base. We sought comment on whether section 252(d)(1) forecloses consideration of historical or embedded costs or merely prohibits state commissions from conducting a traditional rate-of-return proceeding to establish prices for interconnection and unbundled network elements. Embedded costs are the costs that the incumbent LECs carry on their accounting books that reflect historical purchase prices, regulatory depreciation rates, system configurations, and operating procedures. We invited parties to comment on whether incumbent LECs should be permitted to recover some portion of their historical or embedded costs over TSLRIC.[1519]

633. In the NPRM, we noted that certain incumbent LECs had advocated that interconnection and access to unbundled element prices be based on the "efficient component

---

[1515] *Competition, The State Experience* at 80 (compilation of written responses by state commission staffs to questions by FCC staff, compiled by NARUC) (March 8, 1996).

[1516] According to information in our possession, such agreements have been negotiated in, among other states, Alabama, Florida, Georgia, Kentucky, Illinois, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee. Letter from W.W. Jordan, Executive Director -- Federal Regulatory, BellSouth, to William F. Caton, Acting Secretary, July 11, 1996 at Attachment (containing chart detailing agreements between BellSouth and new entrants in Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee); "Interconnection Agreement Under Sections 251 and 252 of the telecommunications Act of 1996, by and between, Ameritech Information Industry Services and MFS Intelenet of Illinois, Inc.," dated May 17, 1996 (filed July 25, 1996).

[1517] 47 U.S.C. § 252(d)(1)(B).

[1518] NPRM at para. 123.

[1519] *Id.* at para. 129.

pricing rule" (ECPR).[1520] Under this approach, an incumbent LEC that sells an essential input element, such as interconnection, to a competing network would set the price of that input element equal to "the input's direct per-unit incremental costs plus the opportunity cost to the input supplier of the sale of a unit of input."[1521] We tentatively concluded in the NPRM that ECPR or equivalent methodologies are inconsistent with the section 252(d)(1) requirement that rates be based on "cost," and we proposed to preclude the states from using this methodology.[1522]

634. Section 254 requires the Commission and the Joint Board established thereunder to ensure that "[a]ll providers of telecommunications service . . . make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service . . . ." That section further provides that "[t]here should be specific, predictable, and sufficient Federal and State mechanisms to preserve and advance universal service."[1523] The Conference Committee also explained that these provisions require any such universal service support payment to be, to the extent possible, "explicit, rather than implicit as many support mechanisms are today."[1524] In the NPRM, we sought comment on whether "it would be consistent with sections 251(d)(1) and 254 for states to include any universal service costs or subsidies in the rates they set for interconnection, collocation, and unbundled network elements."[1525] In particular, we discussed the "play or pay" system adopted by the state of New York in which interconnectors that agree to serve all customers in their self-defined service areas ("players") potentially pay a substantially lower interconnection rate than those that serve only selected customers ("payers") and are, therefore, liable to pay additional contribution charges.[1526] We noted that the statutory schedule for the completion of the

---

[1520] *Id.* at para. 147. *See* William J. Baumol, *Some Subtle Issues in Railroad Deregulation*, 10 Int'l J. Trans. Econ. 341 (1983); William Baumol & Gregory Sidak, *Toward Competition in Local Telephony* (1994); William Baumol & Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171 (1994).

[1521] William Baumol & Gregory Sidak, *The Price of Inputs Sold to Competitors*, 11 Yale J. on Reg. 171, 178.

[1522] NPRM at para. 148.

[1523] 47 U.S.C. § 254(b)(4) and (b)(5).

[1524] Joint Explanatory Statement at 130-31. "In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit." *Id.* at 131; *see also* 47 U.S.C. § 254(e).

[1525] NPRM at para. 145.

[1526] *Id.*

universal service reform proceeding (15 months from the enactment of the 1996 Act) is different from that for this proceeding (6 months from the date of enactment of the 1996 Act). We asked whether the ability of states to take universal service support into account differs pending completion of the section 254 Joint Board proceeding or state universal service proceedings, pursuant to section 254(f), during any transition period that may be established in the section 254 proceeding or thereafter.[1527]

(2) Comments

635. *Forward-Looking Costs.* Most new entrants and IXCs agree that prices for interconnection and unbundled elements should be based on forward-looking, economic costs.[1528] Many state commissions also argue that, if federal pricing rules are adopted, forward-looking methodologies should serve as the basis for establishing rates in a competitive environment.[1529] The Department of Justice contends that pricing above forward-looking economic costs would subject competitors to substantial risk of a price squeeze because the real cost of a network element for the incumbent LEC will be its forward-looking economic cost, while the cost to the new entrant will be the higher price charged for the element by the LEC.[1530] Parties favoring a forward-looking, incremental cost methodology argue that it is the appropriate pricing standard for several reasons. First, such an approach simulates the prices for network elements that would result if there were a competitive market for the provision of such elements to other carriers.[1531] In such a market, these parties argue, competition would drive prices to forward-looking costs, even if such costs were lower than a firm's historical costs.[1532] Second, unbundled element prices based on forward-looking economic costs prevent incumbent LECs from exploiting their market power at the expense of

[1527] *Id.*

[1528] *See, e.g.*, ACSI comments at 54-55; AT&T comments at 47; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 59, 61; NEXTLINK comments at 27; Sprint comments at 43-44; Teleport comments at 46; Telecommunications Resellers Ass'n comments 38-39; *see also* Ad Hoc Telecommunications Users Committee comments at 31-34; DoJ comments at 27-32; Frontier comments at 21-22; Texas Public Utility Counsel comments at 33-34; Attorneys General reply at 3; NCTA reply at 18-20; NTIA reply at 17-18 n.35.

[1529] *See, e.g.*, New York Commission comments at 3-4; Missouri Commission comments at 11; Kentucky Commission comments at 4-5; Wyoming Commission comments at 27-28; Ohio Commission comments at 41-43.

[1530] DoJ comments at 28-31.

[1531] *See, e.g.*, DoJ comments at 28-29.

[1532] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.5; DoJ comments at 28-29.

their competitors that are dependent on the incumbent LEC's facilities.[1533] Third, a forward-looking incremental cost methodology creates the right investment incentives for competitive facilities-based entry and creates incentives for the market to move towards competition while preserving opportunities for competition even if some network elements prove to be resistant to competition.[1534] Fourth, a pricing methodology based on forward-looking economic costs minimizes the incumbent LECs' opportunities to engage in anticompetitive cross-subsidization that could delay the emergence of effective competition.[1535] Finally, these parties argue that pricing based on forward-looking economic costs will lead to lower prices for consumers.[1536]

636. While many commenters agree that the proper economic cost standard for interconnection and unbundled elements is one based on forward-looking LRIC, the record indicates a lack of consensus on the precise definition of such a methodology. While many parties, including some incumbent LECs, favor a pricing methodology based on TSLRIC,[1537] others contend that LRIC provides the appropriate basis for pricing interconnection and unbundled elements.[1538] AT&T argues that, because incumbent LECs will be providing access to unbundled network elements and interconnection, and not merely the individual services that use those elements, the relevant question is the incumbent LEC's cost of producing the

[1533] *See, e.g.*, DoJ comments at 30.

[1534] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p.7; DoJ comments at 29; NCTA comments at Appendix B (Unbundling, Interconnection, and Traffic Exchange: The Pricing of Access to Local Exchange Networks), p. 22.

[1535] *See, e.g.*, DoJ comments at 30-31.

[1536] *See, e.g.*, DoJ comments at 28-31.

[1537] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 34-36; AT&T comments at 47-48; ALTS comments at 35-36; Ameritech comments at 63-64 (but must include recovery of joint, common, and residual costs); CFA/CU comments at 26-32 (including a contribution to joint and common costs); Citizens Utilities comments at 18; Comcast comments at 23; CompTel comments at 67-71; Competition Policy Institute comments at 8; DoJ comments at 28-31 (including any joint and common costs); Frontier comments at 21-22; Intermedia comments at 14; LDDS comments at 56, 62; MCI comments at 60-61; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24-25 (including a markup over TSLRIC to reflect a reasonable allocation of joint and common costs); SNET reply at 5-7 (including a reasonable contribution to common costs); Sprint comments at 44 (plus a reasonable contribution to joint and common costs), reply at 28-32; TCC comments at 14.

[1538] *See, e.g.*, Texas Statewide Tel. Cooperative comments at 8-11, 14.

entire demand for network elements.[1539] Because TSLRIC defines a cost increment relative to a hypothetical situation in which the supplier does not currently provide the network element at all and thus must construct and operate all element-specific facilities necessary to produce the network element, AT&T believes that TSLRIC, unlike LRIC, includes all element-specific fixed costs.[1540]

637. The Consumer Federation of America argues that costs must be analyzed consistently across all major services using the same cost methodology, *i.e.*, individual functionalities or specific capacities must have similar costs across services.[1541] AT&T argues that TSLRIC should exclude all costs attributable to the incumbent LECs' retailing operations, and that all other cost allocations should be competitively-neutral and assigned on an equally proportional basis relative to attributable costs.[1542] ALTS argues that the underlying data from a TSLRIC study should be accessible for purposes of replicating the study methods and comparisons to other public data.[1543] NTIA contends that the Commission should require the states to consider recovery of only those costs that the incumbent can convincingly demonstrate are incurred in service provisioning.[1544] Supporters of a forward-looking economic cost methodology argue that TSLRIC studies can be prepared quickly to establish interconnection and unbundled element prices.[1545]

638. Incumbent LECs generally oppose the adoption of a forward-looking, long-run incremental costing methodology.[1546] At least five major reasons are offered in opposition. First, opponents of a forward-looking, long-run incremental costing methodology argue that setting the price of each discrete service based on LRIC will not recover the total costs of the

[1539] AT&T comments at 47, Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.6.

[1540] *Id.* at 48.

[1541] CFA/CU comments at 32.

[1542] AT&T comments at 61-62, 64-65.

[1543] ALTS comments at 36-37.

[1544] NTIA reply at 28.

[1545] *See, e.g.*, LDDS comments at 64-65.

[1546] *See, e.g.*, Matanuska comments at 3-4; NYNEX comments at 46-47; PacTel comments at 66-67; TCA comments at 8.

network because if prices are set equal to the cost of the last unit, total revenues will fall short of total costs.[1547] Second, PacTel argues that a forward-looking cost methodology also suffers from the "fallacy of perfect competition" because it does not account for the fact that, while it is true that competition drives the price of every product toward incremental cost, every multi-product firm must have some products priced far enough above incremental cost to recover its total costs and return a profit to investors.[1548] Third, incumbent LECs argue that setting prices based on the forward-looking economic cost of the element will not create incentives for new entrants to build their own facilities,[1549] and will discourage efficient entry and useful investment by both incumbent LECs and their competitors.[1550] Fourth, some opponents of a forward-looking, economic cost methodology contend that such an approach raises significant practical and administrative problems because LRIC studies are expensive to conduct, almost impossible to audit or review particularly for small entities seeking to enter the local exchange market, highly subjective, and the necessary data are under the exclusive control of the party subject to the agreement.[1551] USTA and other commenters also argue that use of LRIC cost studies would fail to capture differences in geographic regions, thereby denying small incumbent LECs a reasonable opportunity to recover their costs.[1552] Finally, many opponents of a forward-looking, economic cost approach to pricing interconnection and access to unbundled elements argue also that such a methodology precludes any contribution to joint and common costs and does not allow the recovery of historical costs.[1553] These parties contend that network providers must be permitted to recover their total costs of service, including a return on investment and a reasonable allocation of joint, common, and

[1547] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp.3-4; NECA comments at 8; Rural Tel. Coalition comments at 25.

[1548] PacTel comments at 68-69; *see also* Rural Tel. Coalition reply at 26-27.

[1549] *See, e.g.*, Bell Atlantic comments at 38; SBC comments at 91-92.

[1550] *See, e.g.*, PacTel comments at 70; SBC comments at 90-92; *see also* U S West comments at Exhibit A (Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange), p.9.

[1551] *See, e.g.*, Bell Atlantic comments at Attachment 2 (Declaration of Robert W. Crandall), p.8; MFS comments at 54, reply at 11-12; NECA comments at 8.

[1552] *E.g.*, USTA comments at 45-50; Bay Springs reply at 8.

[1553] *See, e.g.*, BellSouth comments at 56-57; NYNEX comments at 50-52; PacTel comments at 65-66; SBC comments at 88, reply at 24-25; U S West reply at 9, 12 (stating that depreciation expenses should be properly allocated); *see also* NECA comments at 8; TCA comments at 8-9. For a discussion of recovery of joint, common, and embedded costs, *see infra* Section VII.B.2.a.

historical costs.[1554]

639. Incumbent LECs generally contend that costs should be based on the individual incumbent LEC's existing network design and technology instead of the idealized least-cost, most efficient network design and technology.[1555] USTA argues that, if competitors want to use an incumbent LEC's embedded plant, competitors should pay for the existing plant, not some theoretical, more efficient plant.[1556] In addition, these parties argue that, if a new entrant can purchase the unbundled element from the incumbent LEC at a price no higher than the cost of the least-cost, most efficient provider, then the new entrant has little incentive to invest in its own facilities. Ameritech also contends that section 252(d)(1) addresses recovery of the incumbent LEC's costs of providing interconnection and unbundled network elements, not the costs of a hypothetical carrier.[1557]

640. On the other hand, several new entrants argue that a forward-looking economic cost methodology should be based on an efficient provider's costs of producing a service.[1558] These parties contend that, in a competitive market, prices are determined by the cost of efficient potential entrants, not the embedded costs of existing firms.[1559] In addition, a pricing standard based on the costs of the element using the most-efficient technology prevents incumbent LECs from charging competitors for the cost of facilities that would in fact be used in large part by the incumbent LECs themselves to compete in new markets such as

---

[1554] *See, e.g.*, Ameritech comments at 60, reply at 30-33 (stating that residual cost recovery must also be permitted); Bell Atlantic comments at 35-36 (stating that the recovery of the total costs of constructing and operating the networks must also be permitted); NYNEX comments at 42-44; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), pp.5-6.

[1555] *See, e.g.*, Ameritech reply at 32-33; Bell Atlantic reply at 17-18; Bellsouth reply at 36-37; *see also* GVNW comments at 36; USTA comments at 40, reply at 21-22.

[1556] USTA comments at 40.

[1557] Ameritech reply at 32.

[1558] *See, e.g.*, ACSI comments at 56; AT&T comments at 57-60 (optimally configured and sized assets with current technology and efficient operating practices); AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), p. 10 (efficient, cost-minimizing competitor); GST comments at 26-27 (costs of an efficient LEC rather than the actual costs of an incumbent LEC); Teleport reply at 30 (best available technology at today's prices); *see also* DoJ reply at 9-11 (best generally available technology); Louisiana Commission comments at 4, 15; Telecommunications Resellers Ass'n comments at 38 (most efficient available technology).

[1559] *See, e.g.*, TCC comments at 17.

interexchange service.[1560] Sprint, however, argues that prices should be based on the incumbent LEC's average utilization and existing network design and technology, not on an idealized network and technology that may bear no relationship to the incumbent LECs existing operations.[1561]

641. USTA, Bell Atlantic, and BellSouth have asserted in various filings and *ex parte* presentations that TSLRIC-based pricing would not properly compensate incumbent LECs for certain factors that affect capital costs and economic depreciation rates.[1562] First, when technological progress lowers equipment costs, the replacement or forward-looking economic cost of certain durable sunk investments can be expected to decline over time. In this case the correct measure of cost over any period of time should include the expected decline in economic value during that period.[1563]

642. Second, these parties argue that, when investments in facilities needed to meet a specific level of demand are sunk and irreversible, an incumbent LEC may not be able to recover these costs over the physical life of the facility, because demand may decrease as new entrants elect to build their own facilities. When entry is possible using current technology, either competition from these entrants, or rate regulation can prevent retail service prices from rising significantly, which will place an effective ceiling on profits. If demand for a service falls in a market in which the incumbent LEC is the only supplier and owner of sunk facilities, however, there will be no corresponding exit of other carriers that will prevent prices and profits from falling. Because of this asymmetric effect of changing market conditions on an incumbent LEC's profits, these parties claim that increasing the uncertainty due to entry in the local exchange market will increase the cost of capital to the incumbent LEC. They then assert that the inability of TSLRIC to account for the risks associated with sunk facilities can lead to understating the true economic cost of an element by a factor of

---

[1560] DoJ reply at 10.

[1561] Sprint reply at 31-32.

[1562] USTA reply comments at Attachment 1 (Reply Affidavit of Jerry A. Hausman); Bell Atlantic comments at Attachment 1 (Affidavit of Jerry A. Hausman); Letter from Robert T. Blau, Vice President, Executive and Federal Regulatory Affairs, BellSouth, to William F. Caton, Acting Secretary, FCC, July 25, 1996, at Attachment (Response to Hubbard and Lehr).

[1563] We note that USTA seems to present a contradictory argument regarding the expected effect of this issue -- here Hausman claims that prices will decrease rapidly, whereas in our price cap proceeding, USTA sponsored testimony by Christenson that claimed input prices would generally increase at the rate of inflation. USTA comments in CC Docket No. 94-1, at 25-27.

three.[1564] Finally they assert that empirical research that shows firms' hurdle rates in excess of the market cost of capital shows that the considerations of risk associated with sunk investment significantly raises a firm's cost of capital.[1565]

643. *Joint and Common Costs.* Several incumbent LECs contend that a forward-looking, economic cost methodology does not take into account either joint or common costs.[1566] Although a few parties contend that incumbent LECs do not need a mark-up over TSLRIC to recover joint and common costs because incumbents are presumably already recovering these costs,[1567] commenters generally agree that incumbent LECs should be permitted to recover some measure of forward-looking joint and common costs.[1568] These commenters argue that pricing at incremental cost without joint and common costs is economically inefficient because it permits competitors to offer the incumbent LECs' services without making a contribution to the common costs that the LECs incur in offering the service.[1569] They further contend that excluding recovery of joint and common costs will distort technological decisions because the LEC is encouraged to invest in less efficient technologies that have higher incremental costs and lower common costs, which would tend to destroy economies of scope.[1570] Finally, incumbent LECs fear that they will be forced to increase retail rates to recover these unrecovered common costs, while their competitors that do not face such costs will reduce their own prices and have little incentive to invest in

[1564] *See* USTA reply at Attachment 1 (Reply Affidavit of Jerry A. Hausman), p.1.

[1565] *Id.* at 7.

[1566] *See, e.g.*, Bell Atlantic comments at Tab 2 (Declaration of Robert W. Crandall), p.9, reply at Attachment 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), p.6; BellSouth comments at 51; Municipal Utilities comments at 19-21; SBC reply at 24-25; TDS comments at 18-19.

[1567] *See* Telecommunications Resellers Ass'n comments at 39-40; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29, reply at 9-10.

[1568] *See, e.g.*, Ameritech comments at 60; Bell Atlantic comments at 36; Citizens Utilities comments at 19; Cincinnati Bell comments at 24-25; Colorado Commission comments 45-46; DoJ reply at 6; GTE Comments at 61-62; Kentucky Commission comments at 5; Lincoln Tel. comments at 13; Mass. Commission comments at 11-12; NCTA comments at 49-50; Ohio Consumers' Counsel comments at 24; SBC comments at 91; Sprint comments at 43-44; AT&T reply at 28; NTIA reply at 19-21; USTA reply at 19.

[1569] *E.g.*, BellSouth comments at 52-53; GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.3.

[1570] *See, e.g.*, BellSouth comments at 53; Lincoln Tel. comments at 13.

facilities of their own.[1571]

644. There is no consensus in the record on the magnitude of the joint and common costs at stake. Although commenters argued that the amount of common costs varies dramatically due to differences in location, network construction, and equipment,[1572] several parties are skeptical that there are significant joint and common costs between network elements given the relative modularity of the network and associated functions.[1573] These parties contend that, if joint and common costs are incurred, incumbent LECs must quantify them so that a state commission can determine whether and precisely how much contribution is needed.[1574] The Department of Justice asserts that, when developing a TSLRIC for unbundled network elements, it is preferable, where possible, to focus on costs of facilities and network elements rather than services that use those facilities in order to arrive at a more accurate determination of economic costs and to reduce the amount of costs that must be treated as joint or common.[1575] The incumbent LECs disagree with the new entrants' characterization of these costs as *de minimis* and argue that there is no evidence that unrecovered joint and common costs are much lower in the TSLRIC rates for physical elements than a TSLRIC standard based on the cost of providing services.[1576]

645. There is considerable disagreement in the record over the appropriate method of allocating joint and common costs under a TSLRIC approach. AT&T contends that the vast majority of the relevant costs will be causally attributed to particular network elements in the calculation of TSLRIC, and that we should prescribe rigid allocators that limit the incumbents' ability to manipulate prices by imposing high markups on new entrants.[1577] This approach, it is argued, is more competitively neutral than Ramsey pricing, which allocates

[1571] *E.g.*, BellSouth comments at 53-54.

[1572] *See, e.g.*, Municipal Utilities comments at 19-20; NARUC reply at 9.

[1573] *See, e.g.*, AT&T comments at Attachment or Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.13-14; Competition Policy Institute comments at 19; DJ comments at 31-32, reply at 8; Texas Public Utility Counsel comments at 24-25.

[1574] Texas Public Utility Counsel comments at 17-28; Sprint comments at 47-50.

[1575] DoJ reply at 8; *see also* Competition Policy Institute comments at 19.

[1576] *E.g.*, PacTel reply at 27; *see also* Cincinnati Bell reply at 10.

[1577] *See* AT&T comments at 61-62.

costs based on inverse demand elasticity.[1578] In contrast, incumbent LECs advocate allocation of joint and common costs based on inverse demand elasticity,[1579] *i.e.*, according to Ramsey pricing principles.[1580] New entrants and other parties oppose the use of Ramsey pricing for interconnection and unbundled network elements for use in a market that is moving toward competition over the long-run.[1581] They contend that Ramsey pricing enables LECs to shift costs associated with entry into new competitive markets over to captive services.[1582] One state commission responds that the Commission's concern in this regard would be addressed by calculating demand elasticities on the basis of the total industry demand for the service, which would negate the influence of competition on demand elasticities.[1583]

646. Commenters suggested other means of allocating joint and common costs. For example, certain incumbent LECs argue that these costs must not be shifted from interconnection and unbundled elements to residential subscribers,[1584] while certain new entrants suggest that these costs should be recovered at the retail level.[1585] Many new entrants agree that the Commission should require allocation of joint and common costs that minimizes the opportunity for incumbent LECs to harm competitors through strategic pricing.[1586] For example, some new entrants argue that states should be required to minimize allocation of

[1578] *See, e.g.*, Teleport comments at 47-48.

[1579] *See e.g.*, GTE comments at 63, comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), pp.4-6; *see also* Mass. Commission comments at 11-12.

[1580] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991).

[1581] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 39-41; CompTel comments at 79-80; MECA comments at 45; Teleport comments at 47-48; Texas Public Utility Counsel comments at 27; WinStar reply at 10-11.

[1582] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 38-39.

[1583] *See, e.g.*, Mass. Commission comments at 12.

[1584] *See, e.g.*, Puerto Rico Tel. comments at 10; Rural Tel. Coalition comments at 27.

[1585] *E.g.*, MCI reply at 9-10.

[1586] *See, e.g.*, MCI reply at 9-10.

joint and common costs to bottleneck or essential network elements.[1587] MCI and Sprint assert that such costs should be spread across all services provided by a carrier in proportion to the TSLRIC for each service.[1588] A few commenters assert that the Commission should adopt a fixed mark-up over TSLRIC for allocation of joint and common costs.[1589] Cable & Wireless supports the adoption of a rule that allocates common costs uniformly for all services offered. It argues that a disproportionate allocation system, that for example, assigns common costs strictly to retail services purchased for resale by small companies, but not to unbundled network elements utilized by larger competitors, would prove detrimental to the development of local competition.[1590] Finally, certain parties suggested that regardless of the method ultimately used to allocate joint and common costs, TSLRIC should serve as the floor[1591] and prices should not exceed stand-alone costs.[1592]

647. *Reasonable Profit.* Commenters disagree over what should constitute a "reasonable profit." Numerous commenters argue that a TSLRIC-based methodology for the pricing of interconnection and unbundled network elements includes a reasonable profit and is, therefore, consistent with the 1996 Act.[1593] These commenters argue that economic

[1587] *See, e.g.*, LCI comments at 4-5 (even under a TSLRIC methodology, it may be necessary to allocate joint direct costs among classes of service); Time Warner comments at 52-53 (only elements that can be duplicated by competitors or that are already available from other sources should include a reasonable markup over TSLRIC for shared and common costs); *see also* CFA/CU comments at 33-35 (allocation to such elements should be no more than the allocation of such costs to basic service).

[1588] *See* AT&T comments at 64; MCI reply at 9-10; Sprint comments at 47.

[1589] *See, e.g.*, Competition Policy Institute comments at 19 (suggesting an overhead loading of six percent); *see also* Sprint comments at 48-49 (joint and common costs should be no more than 15 percent of TSLRIC).

[1590] Cable & Wireless comments at 35.

[1591] *See, e.g.*, Citizens Utilities comments at 19; Florida Commission comments at 26; SBC comments at 93-94.

[1592] *See, e.g.*, AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.14-15; TDS comments at 21.

[1593] *See, e.g.*, CompTel comments at 69-70; LDDS comments at 61; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29; Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p.12.

measures, such as TSLRIC, reflect a reasonable profit by including the cost of capital.[1594] Time Warner and NEXTLINK contend that permitting incumbent LECs to receive a profit above that contained within TSLRIC pricing would provide them with a greater return on facilities than was permitted under rate-of-return regulation by "double-counting" the profit.[1595] Furthermore, NEXTLINK rejects the notion that profit includes the recovery of embedded costs or is a means of recovering subsidies for universal service currently recovered through access charges such as the transport interconnection charge or carrier common line charge, or their intrastate equivalents.[1596] Similarly, LDDS believes that "reasonable profit" cannot be read to include contribution to costs having nothing to do with providing the network elements or interconnection that are the subject of a section 252 pricing standard.[1597]

648. Incumbent LECs, however, contend that setting rates on a TSLRIC-based methodology alone would violate section 252(d)(1) by precluding recovery of a reasonable profit.[1598] NYNEX and USTA state that profit is what a firm makes after it recovers its total costs of providing all of its services, including its investment-related costs.[1599] Ameritech similarly contends that the term "reasonable profit" means the ability to earn positive economic profits as an incentive for efficiency and innovation.[1600] PacTel argues that, in order to allow for a reasonable profit, rates for interconnection and unbundled elements must permit full recovery of historical accounting costs. PacTel charges that the federal courts have held that the determination of a "reasonable profit" should consider the effect on the carrier's whole enterprise and, therefore, the sum of the carrier's rates must enable it to

[1594] *E.g.*, AT&T reply at 31; CompTel comments at 69-70, reply at 39; DoJ reply at 9; Frontier reply at 12-15; MCI comments at 61-62; Texas Public Utility Counsel comments at 19-20; WinStar comments at 29.

[1595] NEXTLINK comments at 28; Time Warner reply at 31-32.

[1596] NEXTLINK comments at 28-29.

[1597] LDDS comments at 61.

[1598] *See, e.g.*, GTE comments at 60; NYNEX comments at 51-52; PacTel comments at 69; SBC comments at 88; TCA comments at 9; TDS comments at 18; *see also* GTE comments at Attachment 3 (Affidavit of Edward C. Beauvais, Ph.D.), p.9.

[1599] *See* NYNEX comments at 42; USTA comments at 43.

[1600] *See* Ameritech comments at 70-71.

recover its total historical costs.[1601]

649. Several parties contend that the issue of what constitutes a reasonable profit should be left to the states. Citizens Utilities contends that the issue of whether profit is reasonable is a question of fact to be resolved, where necessary, in arbitration proceedings.[1602] Time Warner argues that what constitutes reasonable profit should, as a matter of policy, vary depending on the nature of the facilities or services being provided and should, therefore, be left to the states.[1603] The Illinois Commission argues that states may even use rate-of-return methodologies for the determination of reasonable profit.[1604]

650. There is also disagreement among the commenters regarding the force of the reasonable profit language in section 252. While many incumbent LECs interpret Section 252(d)(1) as *requiring* prices to include a reasonable profit,[1605] certain new entrants and other parties argue that the reasonable profit language is permissive, not mandatory.[1606] For example, several LECs contend that, to avoid confiscation of their property, LECs are entitled to full operating expenses as well as the capital costs of doing business and a reasonable profit.[1607] The Ohio Consumers' Counsel, however, argues that the language of section 252(d)(1) indicates that it is at the discretion of the state commissions to determine whether to allow rates to reflect a reasonable profit.[1608]

651. USTA contends that "purely forward-looking TSLRIC" should not be the price

[1601] *See* PacTel comments at 65-66, *citing FPC v. Hope Natural Gas*, 320 U.S. 591 (1944) and *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1172 (D.C. Cir. 1987).

[1602] Citizens Utilities comments at 17.

[1603] Time Warner comments at 52.

[1604] Illinois Commission reply at 15.

[1605] *See, e.g.*, PacTel comments at 65-66.

[1606] *See, e.g.*, AT&T reply at 31; Cox reply at 29; DoJ reply at 15.

[1607] *See, e.g.*, MECA comments at 44, 49; PacTel comments at 65-67.

[1608] Ohio Consumers' Counsel comments at 26.

for interconnection elements because "telecommunications networks are mostly sunk costs."[1609] It argues that, when investment in facilities requires sunk and irreversible costs, a firm may not be able to recover this investment over the physical life of the facilities due to the risks of decreases in value resulting from future competition. USTA contends that allowing other carriers into the provision of local exchange service will subject incumbent LECs to these types of risks. It then claims that TSLRIC calculations do not appropriately account for these additional risks.

652. USTA also argues that the risks to which the incumbent LECs will be subject as a result of competition in the local exchange market include the risks from facing new competition, technological change, change in demand, and interest rates. It further argues that these risks will result in many situations in which the incumbent LECs may face a reduction in profits (downside risk) and no situations in which the incumbent LECs may see an increase in their profits. Thus, incumbent LECs must be compensated for these additional risks, according to USTA. It concludes that TSLRIC calculations fail to provide this compensation, stating "TSLRIC can be biased downward by a factor of three."[1610]

653. Similarly, Bell Atlantic asserts that, in a market where input prices are declining, a TSLRIC standard is not the appropriate standard because, "in a world of continual technological progress, it would be irrational for firms constantly to update their facilities in order completely to incorporate today's lowest-cost technology."[1611] Thus, it argues that because a carrier would not replace its entire existing set of facilities (a sunk investment) with the best available technology at a given point, the price of the best available technology understates the cost of providing service.[1612]

654. The Consumer Federation of America, disputing the incumbent LECs' claims regarding risk premiums, argues that risk premiums are reflected in the large returns incumbent LECs have already earned.[1613]

655. *Embedded Costs.* IXCs, competitive local entrants, and others interpret section

[1609] *See* USTA reply at Attachment 1 (Reply Affidavit of Professor Jerry A. Hausman), p.1.

[1610] *Id.* at 6. Presumably, by TSLRIC, Professor Hausman is referring to a TSLRIC assuming a risk free rate of return and a depreciation rate that encompasses the physical life of assets.

[1611] Bell Atlantic reply at Exhibit 1 (Declaration of Alfred E. Kahn and Timothy J. Tardiff), para.8a.

[1612] *Id.*

[1613] *See* CFA/CU comments at 61-63.

251(d)(1) as precluding states from setting rates by use of traditional cost-of-service regulation, with its detailed examination of historical accounting costs and reliance on an embedded rate base.[1614] These parties argue that some measure of forward-looking economic costs, not historical costs, should be the only basis for setting rates for interconnection and unbundled network elements because only forward-looking economic costs meet the statutory requirement in section 252(d)(1) that such rates be "determined without reference to a traditional rate-of-return or other rate-based proceeding." Potential new entrants and many other commenters argue that historical or embedded costs should not be included in the prices of interconnection and unbundled network elements.[1615] NTIA asserts that it is unwise to include in the prices for interconnection and unbundled elements an amount to recover historical costs when the size of any shortfall between historical costs and TSLRIC's forward-looking costs will not be determined for many years after interLATA entry.[1616] These parties contend that permitting incumbent LECs to recover embedded costs in the prices they charge competitors for interconnection and unbundled network elements, while the incumbents experience much lower incremental costs, will result in inefficiently high prices that will either cause new entrants to over-build existing systems instead of maximizing the efficient use of the existing incumbent LEC's network, or discourage entry and investment in the local markets altogether.[1617] Moreover, opponents of embedded cost recovery maintain that these costs reflect past inefficiencies and their recovery does not create any incentive for incumbent LECs to maximize their network and operational efficiencies.[1618] Commenters also argue that embedded cost recovery permits incumbents to engage in anticompetitive, strategic,

[1614] *See, e.g.*, AT&T comments at 47; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Sprint comments at 43; Teleport comments at 46; Time Warner comments at 51; Frontier comments at 21; Excel comments at 9; ACSI comments at 54-55; WinStar comments at 37-38; GST comments at 29-30; *see also* Ad Hoc Telecommunications Users Committee comments at 30-31; DoJ comments at 27-32, reply at 14; Kentucky Commission comments at 4; Texas Public Utility Counsel comments at 33-34; Telecommunications Resellers Ass'n comments at 38; Michigan Commission comments at 14; Pennsylvania Commission comments at 29; Ohio Commission comments at 42-43; Attorneys General reply at 7-8.

[1615] *See, e.g.*, AT&T comments at 47; CFA/CU reply at 18-19; DoJ comments at 27-32; N. Economides comments at 3; Frontier comments at 21-22, reply at 13; Jones Intercable comments at 25-26; LDDS comments at 60; MCI comments at 61-62; MFS comments at 59; Michigan Commission comments at 14; Sprint comments at 43; Teleport comments at 46; TCC comments at 15-16; Texas Public Utility Counsel comments at 33-34; Time Warner comments at 51; WinStar comments at 37-38; *see also* Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), pp.2-6;

[1616] *See* NTIA reply at 28-29.

[1617] *See, e.g.*, Competition Policy Institute comments at 8; TCC comments at 15-16.

[1618] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 53-54.

or discriminatory pricing by manipulating the cost of individual rate elements.[1619]

656. In response to claims that the incumbent LECs are entitled to recover embedded costs incurred as a result of their regulation, opponents of embedded cost recovery argue that, at the state level, incumbent LECs have been opting for incentive-based regulation and so have foregone the right to claim entitlement to recovery of embedded costs in exchange for the flexibility to price their services to meet competition.[1620] AT&T argues that, because the majority of the incumbent LECs' embedded plant was installed after 1990, the forward-looking replacement costs of this old plant may in many cases be higher than the incumbent LECs' embedded costs.[1621] MCI disagrees with incumbent LECs' claims that excluding historical costs will discourage future investment by incumbent LECs and argues instead that incumbent LECs make investment decisions based upon expected future earnings.[1622]

657. Most incumbent LECs and some other parties dispute the claim that historical costs are precluded by the statute,[1623] asserting instead that section 252(d)(1) merely prohibits the use of a rate-of-return *proceeding* to determine such rates.[1624] Incumbent LECs argue that any pricing methodology the Commission adopts should permit recovery of historical or embedded costs in the prices of interconnection and unbundled network elements.[1625] NYNEX specifically proposes a cost-accounting pricing methodology that places the burden on the incumbent LEC to identify the specific accounting data that would be associated with the

[1619] TCC comments at 15-16

[1620] *See, e.g.*, GST comments at 29-30; WinStar comments at 38.

[1621] *See* AT&T reply at 33. For a detailed discussion, *see* AT&T reply at Appendix C (Affidavit of Lee Selwyn and Patricia Kravtin), pp.1-4.

[1622] *See* MCI reply at 15-16.

[1623] *See, e.g.*, Bell Atlantic comments at 37; BellSouth reply at 35-37; Colorado Commission comments at 34-35; GVNW comments at 35-36; Municipal Utilities comments at 19; NYNEX comments at 46-47; Ohio Consumers' Counsel comments at 23; PacTel comments at 65; Roseville Tel. comments at 6-8; Rural Tel. Coalition comments at 26-28; SBC comments at 88; TDS comments at 17-18; Texas Statewide Telephone Coop. Inc. comments at 7; USTA comments at 40.

[1624] *See, e.g.*, Bell Atlantic comments at 37; Municipal Utilities comments at 19; Ohio Consumers' Counsel comments at 23; Texas Statewide Telephone Coop. comments at 7.

[1625] *See, e.g.*, Alaska Tel. Ass'n comments at 4-5; Ameritech comments at 60; Bell Atlantic comments at 36; Cincinnati Bell comments at 30; Lincoln Tel. comments at 11-12; Roseville Tel. comments at 7-8; SBC comments at 59; SNET comments at 29; USTA comments at 40; *see also* NECA comments at 6, reply at 8-9.

particular type of interconnection requested by the competing carrier under section 251.[1626]

658. USTA cites reports that estimate that embedded costs that would not be recouped under a solely forward-looking pricing methodology are between $13 billion and $18.4 billion.[1627] Incumbent LECs contend that, because incumbent LECs must offset this shortfall of revenues against total costs that is created by a failure to recover embedded costs, they will be discouraged from investing to maintain and upgrade their networks in order to avoid the risk of again being unable to recover embedded costs.[1628] In addition, they argue that they incurred these embedded costs under federal and state regulatory oversight, which imposed on incumbent LECs social policy obligations and uneconomic costing practices, and that they therefore should be permitted to recover them.[1629] Incumbent LECs also assert that past investments were made under the belief that costs would be recovered, and that rates collected in the past did not reflect the risk that embedded costs might not be recovered in future rates.[1630] Several commenters argue that the opportunity to recover embedded costs through rates for interconnection and unbundled elements is particularly important for small and rural incumbent LECs.[1631] Finally, some parties also contend that, if they are not permitted to recover embedded costs, these costs must be recouped elsewhere, thus putting pressure on the states to recover these costs through local rates.[1632]

659. Despite their objections to embedded cost recovery, some non-incumbent parties explain conditions under which some limited recovery should be permitted. For example, MCI argues that, although embedded costs should not be recovered, it would be appropriate to

[1626] NYNEX comments 54-56, reply at 27.

[1627] USTA comments at 55.

[1628] *See, e.g.*, Bell Atlantic comments at Attachment 1 (Affidavit of Professor Jerry A. Hausman), p.2; Lincoln Tel. comments at 16-17; USTA reply at 23.

[1629] *See, e.g.*, Ameritech reply at 30-31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

[1630] *See* Bell Atlantic reply at Exhibit 2 (Declaration of Richard A. Epstein), p.4.

[1631] *E.g.*, Home Tel. comments at 4; NECA comments at 9; TCA comments at 8; Texas Statewide Tel. Cooperative, Inc. comments at 9; Bay Springs reply at 10.

[1632] *See, e.g.*, USTA comments at 56; Wyoming Commission comments at 31-32; *see also* New York Commission reply at 9; *cf.*, Alabama Commission comments at 24-25; Texas Commission comments at 23, 26.

allow incumbent LECs to recover any depreciation reserve deficiency,[1633] which MCI estimates is only a small percentage of the residual between existing revenues and the revenues generated by a forward-looking, TSLRIC pricing of unbundled network elements.[1634] The Ad Hoc Telecommunications Users Committee asserts that, at a minimum, any nominal losses in economic value attributed to stranded investment should be weighed against the appreciation in value that incumbent LECs have experienced as reflected in share prices and market-to-book ratios.[1635] The Consumer Federation of America proposes that stranded investment might be recovered through an industry-wide recovery fund, if incumbent LECs can satisfy a rigorous set of showings to ensure that ratepayers are fairly treated.[1636] Finally, AT&T argues that, if the Commission determines that some portion of the residual should be recovered, it should be recovered through a competitively neutral, transitional, funding and distribution mechanism that will not distort competition.[1637]

660. *Opportunity Cost -- ECPR.* Incumbent LECs are the primary advocates for ECPR pricing of interconnection and unbundled network elements.[1638] They argue generally that ECPR is the approach that most closely parallels the method a firm in a competitive market would employ when faced with the opportunity of selling inputs to firms that intend to compete with it in its final product market.[1639] GTE asserts that the ECPR's purpose is to reward efficient entry into the market for the end product by ensuring that the incumbent LEC

[1633] A reserve imbalance exists when the carrier's actual "book" depreciation reserve differs from its "theoretical" reserve, which is the reserve which would exist if service lives and salvage values had been accurately forecast in the past. When the theoretical reserve exceeds the book reserve, the imbalance is a reserve deficiency. For most LECs the reserve imbalance is an overall deficiency. *Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers*, CC Docket No. 87-447, Report and Order, 3 FCC Rcd 984 (1988).

[1634] *See* MCI comments at 73-75.

[1635] Ad Hoc Telecommunications Users Committee comments at 26-27.

[1636] *See* CFA/CU comments at 67-68.

[1637] *See* AT&T comments at 70-73.

[1638] *See, e.g.*, Ameritech comments at 91-93; GTE reply at 36-38; MECA comments at 50-52; PacTel comments at 69-71; SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5; *see also* PacTel reply at Appendix C (Declaration of Richard D. Emerson).

[1639] *See, e.g.*, Rural Tel. Coalition reply at 28-30.

sells network access to itself and to its rivals on the same, nondiscriminatory terms.[1640] Thus, GTE claims, the ECPR sets prices for network elements that provide incentives for efficient entry and compensates incumbent LECs for the economic costs associated with sale of such elements.[1641] GTE further argues that ECPR accomplishes these tasks regardless of the market structure and regardless of the presence or absence of economic rents.[1642] SBC argues that the ECPR is equivalent to the avoided cost rule used for setting the prices of resold services and equivalent to the efficient imputation rule for pricing of retail services.[1643] Supporters of ECPR pricing also argue that prices will continue to move toward competitive levels where competition is provided by a more efficient carrier than the incumbent LEC.[1644]

661. New entrants and many other commenters oppose the use of the ECPR to set prices for interconnection and access to unbundled network elements.[1645] These parties argue that ECPR does not comply with the statutory mandate that interconnection and network elements be based on costs. They assert that using ECPR would allow incumbent LECs to retain monopoly rents and protect the incumbent LECs from competitive disciplinary market forces.[1646] Opponents of ECPR contend that ECPR pricing does not replicate a competitive environment, but instead perpetuates inefficient and anticompetitive aspects of the current pricing structure. Other commenters argue that the incumbent LECs may use ECPR to exclude or marginalize a more efficient rival in the complementary market by forcing the rival

[1640] GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.7.

[1641] *Id.* at p.I-i

[1642] *Id.* at p.III-7.

[1643] SBC comments at Appendix A (Efficient Component Pricing Rule), pp.1-5.

[1644] *See, e.g.*, Ameritech comments at 93; GTE comments at Attachment 4 (An Empirical Analysis of Pricing Under Sections 251 and 252 of the Telecommunications Act of 1996), p.III-6-8.

[1645] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 55; ALTS reply at 26-29; Cable & Wireless comments 35; California Commission reply at 20; CFA/CU comments at 41-45; CompTel reply at 40-49; Cox reply at 29; DoJ reply at 11-13; Frontier comments at 23; Mass. Attorney General comments at 6-9; MCI comments at 70-71, reply at 16; MFS comments at 60 n.67; Ohio Consumers' Counsel comments at 25 n.7, reply at 15; Sprint comments at 59 n.33; Texas Public Utility Counsel comments at 36; Time Warner comments at 56-58; Telecommunications Resellers Ass'n comments at 41-42; WinStar comments at 41.

[1646] *See, e.g.*, Cable & Wireless comments 35; California Commission reply at 20; CompTel reply at 40; Mass. Attorney General comments at 6-8; Time Warner comments 56-58; Telecommunications Resellers Ass'n comments at 41-42.

to operate on the higher end of its cost curve through higher interconnection charges. They also argue that prices based on ECPR create incentives for incumbent LECs to shift costs of their competitive services to their bottleneck services, which distorts competition.[1647] Finally, opponents of ECPR assert that ECPR pricing shields the largest share of costs possible from competition, preserves the status quo, and imposes a barrier to entry.[1648]

662. Baumol, Ordover, and Willig, principal authors of the theory, explain that ECPR is not applicable for pricing of interconnection and unbundled network elements because the existing end user rates for local telecommunications are not appropriate as a baseline for ECPR. They claim that cross-subsidies are common in the current rates, and rates depart systematically from pertinent costs. Baumol, Ordover, and Willig conclude that applying ECPR to existing rates would result in component prices that lock in the incumbent LECs' monopoly profits and pricing inefficiencies, and would attract inefficient entry, where rates are too high, and would preclude efficient entry where rates are too low.[1649]

663. *Universal Service Subsidies.* Most parties other than incumbent LECs and some state commissions agree that it would be inconsistent with both the cost-based rate requirements of section 252(d)(1) and the requirement in section 254(b)(5), that universal service support mechanisms "be specific [and] predictable. . ."[1650] for states to include any universal service subsidies in the rates they set for interconnection, collocation, and unbundled network elements.[1651] They argue that the 1996 Act requires that rates reflect the economic cost of providing network elements and interconnection and does not authorize subsidies that have nothing to do with economic costs.[1652] With regard to the requirements of section 254,

[1647] *See, e.g.*, N. Economides comments at 4-6.

[1648] *See, e.g.*, CFA/CU comments at 42.

[1649] *See* AT&T comments at Appendix C (Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.8-9.

[1650] 47 U.S.C. § 254(b)(5).

[1651] *See, e.g.*, ACTA comments at 23; AT&T comments at 70-73; Competition Policy Institute comments at 20; CompTel comments at 73-74; DoJ comments at 56-59; MCI comments at 75; NEXTLINK comments at 29; Sprint comments at 61-62; Telecommunications Resellers Ass'n comments at 39 n.76; Teleport comments at 48-49; WinStar comments at 40-41, reply at 13-14.

[1652] AT&T and CompTel further contend that to permit any universal service subsidies in the rates set for interconnection, collocation and unbundled network elements would be to base rates on the embedded costs of incumbent LEC expenditures rather than the forward-looking economic costs of providing a network element as mandated by section 252(d)(1). *See* AT&T comments at 70-73; CompTel comments at 72-74.

these parties argue that, to the extent rates need to be subsidized for universal service purposes, the subsidy should be collected from all carriers on a non-discriminatory and competitively neutral basis.[1653] The Washington Commission relates its own experience of rejecting US West's request for a per minute universal service charge to cover "carrier of last resort" obligations and its finding that residential rates were sufficient to cover the costs of residential service.[1654]

664. In contrast, several incumbent LECs and state public utility commissions maintain that incumbent LECs should be permitted to recover their embedded costs in the rates set for interconnection, collocation, and unbundled network elements. These commenters claim that rates based on incremental costs alone fail to account for certain costs historically incurred to accomplish carrier-of-last-resort and universal service social policy objectives.[1655] The Attorneys General caution the Commission not to classify legitimate contributions to joint and common costs as impermissible implicit universal service subsidies.[1656]

665. Several parties comment on the issue of how universal service funding should be handled during the interim period between the effective date of this order and the effective date of the Commission's order implementing the section 254 universal service requirements in May 1997. AT&T proposes that the Commission adopt a competitively-neutral funding and distribution mechanism.[1657] CompTel proposes that the Commission grant a blanket waiver of incremental cost pricing for exchange access. Under CompTel's plan, pending completion of the section 254 proceeding, the incumbent LECs would continue to provide exchange access pursuant to their intrastate and interstate carrier-to-carrier access charge tariffs. At the conclusion of the section 254 proceeding, the Commission would determine whether the incumbent LECs are entitled to recover any portion of those revenues from competitive carriers and, if so, devise appropriate mechanisms for doing so. CompTel asserts

[1653] *See, e.g.*, ACTA comments at 23; AT&T comments at 69; Massachusetts Commission comments at 8-10; MCI comments at 75; Michigan Commission comments at 19.

[1654] Washington Commission reply at 6.

[1655] *See, e.g.*, Alabama Commission comments at 24-25; Bay Springs, *et al.* comments at 16; BellSouth comments at 57; Matanuska Tel. comments at 2-3; TDS comments at 20; SBC comments at 89; Western Alliance comments at 6-7; *but see* BellSouth comments at 57 (if the universal service proceeding establishes a federal fund or if the states establish explicit funds, there will be no need for subsidies to be built into interconnection and unbundled network element rates).

[1656] Attorneys General reply at 10-11.

[1657] AT&T comments at 73.

that, by preserving the status quo for exchange access until those issues are fully considered and resolved, the Commission would ensure that the 1996 Act does not cause any unnecessary short-term disruption to carriers or consumers.[1658]

666. The Western Alliance contends that states should have authority to order the recovery of lost contribution through access charges until explicit and competitively neutral support mechanisms are in place.[1659] Similarly, the Massachusetts Commission argues that the states should have authority to include universal service subsidies in the rates for interconnection during this period. The Massachusetts Commission further contends that prohibiting states from exercising this authority will promote inefficient competition and ultimately could result in confiscation claims being filed by incumbent LECs.[1660]

667. Some parties take the position that "play or pay" proposals incorporate implicit subsidies into rates for interconnection and unbundled network elements and are therefore inconsistent with the 1996 Act.[1661] They further argue that such programs violate the 1996 Act because they do not require all telecommunications carriers to contribute on an equitable and nondiscriminatory basis and do not qualify as "specific, predictable and sufficient mechanisms" to preserve and advance universal service.[1662]

668. Other commenters argue, however, that the 1996 Act permits reasonable differences in interconnection rates charged to carriers so long as similarly-situated carriers are treated alike. They maintain that the anti-discrimination provisions of the 1996 Act only prohibit unreasonable discrimination. Thus, they contend that "play or pay" schemes are consistent with the 1996 Act.[1663] Several parties also contend that such schemes are authorized by the reservation of state power to adopt and implement universal service measures in section 254.[1664] Moreover, the New York Commission argues that the section

[1658] CompTel comments at 84.

[1659] Western Alliance comments at 6-7.

[1660] Mass. Commission comments at 9-10.

[1661] *See, e.g.*, Frontier comments at 23; Teleport comments at 48-49; Texas Public Utility Counsel comments at 35-36; WinStar reply at 14 n.20.

[1662] WinStar comments at 40; *see also* Texas Public Utility Counsel comments at 35.

[1663] *See, e.g.*, New York Commission comments at 15-18; NYNEX comments at 91-97.

[1664] NYNEX comments at 95-97; New York Commission reply at 6.

254(e) requirement that universal service funding must be explicit applies only to the federal Universal Service Fund, which is yet to be established, and not to state initiatives.[1665]

669. Some commenters urge the Commission to address universal service in the section 254 proceeding rather than in the section 251/252 interconnection proceeding.[1666] Other commenters suggest that universal service, access restructure, and interconnection issues should be addressed in a coordinated manner or in a consolidated proceeding.[1667]

670. *Fifth Amendment Issues.* Several incumbent LECs claim that use of a LRIC-based pricing methodology that does not permit recovery of at least joint and common costs and a reasonable profit constitutes unlawful confiscation in violation of the Fifth and Fourteenth Amendments.[1668] Other LECs further argue that, in order to avoid an unconstitutional taking, any pricing rules we adopt must enable them to recover total costs, including historical or embedded costs.[1669] Generally, these parties contend that prices limited by a forward-looking economic cost methodology do not permit an incumbent LEC to remain profitable over time because LRIC fails to recover total costs.[1670] They assert that, if the Commission decides now, long after those costs have been sunk, to bar compensatory returns, it will violate due process and undermine the incumbent LECs' legitimate, investment-backed expectations.[1671] Such interference with legitimate investor expectations, they contend, constitutes an unlawful taking.[1672] GTE contends that Commission adoption of a pure TSLRIC methodology would represent an unconstitutional taking, because it would require

[1665] New York Commission reply at 6.

[1666] *See, e.g.*, Competition Policy Institute comments at 13-14; F. Williamson comments at 8; Texas Public Utility Counsel comments at 36; ALTS reply at 35.

[1667] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 35; TDS comments at 20.

[1668] *See, e.g.*, GTE comments at 65-71; MECA comments at 42; Puerto Rico Telephone Company reply at 11-12; PacTel comments at 67.

[1669] *See, e.g.*, NYNEX comments at 43-44; PacTel comments at 65-66; SNET comments at 29; Roseville Tel. comments at 6-7.

[1670] *See, e.g.*, Ameritech comments at 62-70; GTE comments at 68-71, reply at 31-32; USTA comments at 39-42.

[1671] *See, e.g.*, GTE comments at 66-71, reply at 31-33; USTA comments at 40-45, reply at 21-25, 32-34.

[1672] *Id.*

use of the incumbent LEC's physical property, thus giving rise to an obligation to provide just compensation.[1673]

671. Other parties, including the Department of Justice and new entrants, contend that using a forward-looking cost-based pricing methodology for setting the rates for interconnection and unbundled elements does not constitute an unlawful taking.[1674] These commenters point out that many state commissions already utilize a forward-looking cost-based pricing methodology.[1675] They also argue that, because forward-looking cost-based rates capture all costs for interconnection and unbundled network elements, including the risk-adjusted cost of capital, such a methodology would not result in an unlawful taking.[1676] These parties further assert that the LECs' takings claims are premature, not demonstrated with sufficient specificity, and overstate the scope of the constitutional guarantee.[1677] Commenters note that no incumbent LEC has made any effort to demonstrate the actual impact of a LRIC-based pricing methodology on its "financial integrity."[1678] These parties contend that there is no unconstitutional impairment if the shortfall is not sufficient to jeopardize the operating and financial integrity of the utility. Finally, these commenters maintain that there is no constitutional right to a particular rate-setting methodology (*i.e.*, historical cost) and there are no general principles that require every component of an integral whole of a utility service to show a profit.[1679]

[1673] *See* GTE comments at 65-67.

[1674] *See, e.g.*, ALTS reply at 8-11; AT&T comments at 70-71; CompTel reply at 37-40; DoJ reply at 13, 16-19; MCI reply at 18-20.

[1675] *See, e.g.*, AT&T comments at 49-50; Cable & Wireless reply at 24-25; MCI reply at 19. AT&T also notes that when U S West and BellSouth have been new entrants into markets, they have advocated a LRIC approach. AT&T comments at 50-51 n.72.

[1676] *See, e.g.*, Frontier reply at 14; MCI reply at 18-19.

[1677] *See, e.g.*, DoJ reply at 16-18.

[1678] DoJ reply at 16-18; MCI reply at 18.

[1679] *See, e.g.*, Jones Intercable reply at 16-17.

(3) Discussion

672. *Overview.* Having concluded in Section II.D., above, that we have the requisite legal authority and that we should establish national pricing rules, we conclude here that prices for interconnection and unbundled elements pursuant to sections 251(c)(2), 251(c)(3), and 252(d)(1), should be set at forward-looking long-run economic cost. In practice, this will mean that prices are based on the TSLRIC of the network element, which we will call Total Element Long Run Incremental Cost (TELRIC), and will include a reasonable allocation of forward-looking joint and common costs. The 1996 Act encourages competition by removing barriers to entry and providing an opportunity for potential new entrants to purchase unbundled incumbent LEC network elements to compete efficiently to provide local exchange services. We believe that the prices that potential entrants pay for these elements should reflect forward-looking economic costs in order to encourage efficient levels of investment and entry.

673. In this section, we describe this forward-looking, cost-based pricing standard in detail. First, we define the terms we are using, explain how the methodology we are adopting differs from other costing approaches, and describe how it should be implemented. In particular, we explain that the price of a network element should include the forward-looking costs that can be attributed directly to the provision of services using that element, which includes a reasonable return on investment (*i.e.*, "profit"), plus a reasonable share of the forward-looking joint and common costs. Second, we address potential cost measures that must not be included in a TELRIC analysis, such as embedded (or historical) costs, opportunity costs, or universal service subsidies. Finally, we refute arguments that this methodology would violate the incumbent LECs' rights under the Fifth Amendment.

(a) Total Element Long Run Incremental Cost

674. *Definitions of Terms.* In light of the various possible definitions of a number of the critical economic terms used in this context, we begin by defining terms as we use them in this Order. Specifically, we provide definitions for the following terms: "incremental cost;" "economic cost;" "embedded or accounting cost;" "joint cost;" "common cost;" "long run incremental cost;" "total service long run incremental cost;" "total element long run incremental cost." In addition to defining these terms, we explain the economic rationale behind the concepts.

675. Incremental costs are the additional costs (usually expressed as a cost per unit) that a firm will incur as a result of expanding the output of a good or service by producing an additional quantity of the good or service.[1680] Incremental costs are forward-looking in the

[1680] *See* 1 Alfred Kahn *The Economics of Regulation* 66 (1971); William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

sense that these costs are incurred as the output level changes by a given increment.[1681] The costs that are considered incremental will vary greatly depending on the size of the increment. For example, the incremental cost of carrying an additional call from a residence that is already connected to the network to its end office is virtually zero. The incremental cost of connecting a new residence to its end office, however, is the cost of the loop. Forward-looking incremental costs, plus a portion of the forward-looking joint and common costs, are sometimes referred to as "economic costs." Embedded or accounting costs are costs that firms incurred in the past for providing a good or service and are recorded as past operating expenses and depreciation. Due to changes in input prices and technologies, incremental costs may differ from embedded costs of that same increment. In competitive markets, the price of a good or service will tend towards its long-run incremental cost.

676. Certain types of costs arise from the production of multiple products or services. We use the term "joint costs" to refer to costs incurred when two or more outputs are produced in fixed proportion by the same production process (*i.e.*, when one product is produced, a second product is generated by the same production process at no additional cost). The term "common costs" refers to costs that are incurred in connection with the production of multiple products or services, and remains unchanged as the relative proportion of those products or services varies (*e.g.*, the salaries of corporate managers). Such costs may be common to all services provided by the firm or common to only a subset of those services or elements. If a cost is common with respect to a subset of services or elements, for example, a firm avoids that cost only by not providing each and every service or element in the subset. For the purpose of our discussion, we refer to joint and common costs as simply common costs unless the distinction is relevant in a particular context.

677. The term "long run," in the context of "long run incremental cost," refers to a period long enough so that all of a firm's costs become variable or avoidable.[1682] The term "total service," in the context of TSLRIC, indicates that the relevant increment is the entire quantity of the service that a firm produces, rather than just a marginal increment over and above a given level of production. Depending on what services are the subject of a study, TSLRIC may be for a single service or a class of similar services. TSLRIC includes the incremental costs of dedicated facilities and operations that are used by only the service in question. TSLRIC also includes the incremental costs of shared facilities and operations that are used by that service as well as other services.

678. While we are adopting a version of the methodology commonly referred to as

[1681] William Baumol and Gregory Sidak, *Toward Competition in Local Telephony* 57 (1994).

[1682] *See, e.g.*, William Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977) ("The very long run is a period so long that all of the firm's present contracts will have run out, its present plant and equipment will have been worn out or rendered obsolete and will therefore need replacement, etc.").

TSLRIC as the basis for pricing interconnection and unbundled elements, we are coining the term "total element long run incremental cost" (TELRIC) to describe our version of this methodology. The incumbent LEC offerings to be priced using this methodology generally will be "network elements," rather than "telecommunications services," as defined by the 1996 Act.[1683] More fundamentally, we believe that TELRIC-based pricing of discrete network elements or facilities, such as local loops and switching, is likely to be much more economically rational than TSLRIC-based pricing of conventional services, such as interstate access service and local residential or business exchange service. As discussed in greater detail below, separate telecommunications services are typically provided over shared network facilities, the costs of which may be joint or common with respect to some services. The costs of local loops and their associated line cards in local switches, for example, are common with respect to interstate access service and local exchange service, because once these facilities are installed to provide one service they are able to provide the other at no additional cost. By contrast, the network elements, as we have defined them,[1684] largely correspond to distinct network facilities. Therefore, the amount of joint and common costs that must be allocated among separate offerings is likely to be much smaller using a TELRIC methodology rather than a TSLRIC approach that measures the costs of conventional services. Because it is difficult for regulators to determine an economically-optimal allocation of any such joint and common costs, we believe that pricing elements, defined as facilities with associated features and functions, is more reliable from the standpoint of economic efficiency than pricing services that use shared network facilities.

679. *Description of TELRIC-Based Pricing Methodology.* Adopting a pricing methodology based on forward-looking, economic costs best replicates, to the extent possible, the conditions of a competitive market. In addition, a forward-looking cost methodology reduces the ability of an incumbent LEC to engage in anti-competitive behavior. Congress recognized in the 1996 Act that access to the incumbent LECs' bottleneck facilities is critical to making meaningful competition possible. As a result of the availability to competitors of the incumbent LEC's unbundled elements at their economic cost, consumers will be able to reap the benefits of the incumbent LECs' economies of scale and scope, as well as the benefits of competition. Because a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace, it allows the requesting carrier to produce efficiently and to compete effectively, which should drive retail prices to their competitive levels. We believe that our adoption of a forward-looking cost-based pricing methodology should facilitate competition on a reasonable and efficient basis by all firms in the industry by establishing prices for interconnection and unbundled elements based on costs similar to those incurred by the incumbents, which may be expected to reduce the regulatory

[1683] 47 U.S.C. §§ 3(29), 3(46).

[1684] *See supra* Section V.

burdens and economic impact of our decision for many parties, including both small entities seeking to enter the local exchange markets and small incumbent LECs.[1685]

680. We note that incumbent LECs have greater access to the cost information necessary to calculate the incremental cost of the unbundled elements of the network. Given this asymmetric access to cost data, we find that incumbent LECs must prove to the state commission the nature and magnitude of any forward-looking cost that it seeks to recover in the prices of interconnection and unbundled network elements.

681. Some parties express concern that the information required to compute prices based on forward-looking costs is inherently so hypothetical as to be of little or no practical value.[1686] Based on the record before us, we disagree. A number of states, which ultimately will have to review forward-looking cost studies in carrying out their duties under section 252, either have already implemented forward-looking, incremental costing methodologies to set prices for interconnection and unbundled network elements or support the use of such an approach.[1687] While these states have applied somewhat different definitions of, and approaches to setting prices developed on, an incremental cost methodology, the record demonstrates that such approaches are practical and implementable.

682. We conclude that, under a TELRIC methodology, incumbent LECs' prices for interconnection and unbundled network elements shall recover the forward-looking costs directly attributable to the specified element, as well as a reasonable allocation of forward-looking common costs. Per-unit costs shall be derived from total costs using reasonably accurate "fill factors" (estimates of the proportion of a facility that will be "filled" with network usage); that is, the per-unit costs associated with a particular element must be derived by dividing the total cost associated with the element by a reasonable projection of the actual total usage of the element. Directly attributable forward-looking costs include the incremental costs of facilities and operations that are dedicated to the element. Such costs typically include the investment costs and expenses related to primary plant used to provide that element. Directly attributable forward-looking costs also include the incremental costs of

[1685] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1686] *See, e.g.*, GVNW comments at 35; NYNEX comments at 54; USTA comments at 47-50.

[1687] *See, e.g.*, Louisiana Commission comments at 4; Texas Commission comments at 22; Washington Commission comments at 25; California Commission comments at 28-29; Colorado Commission comments at 35; Maryland Commission comments at 7-8; Oklahoma Commission comments at Attachment A (Oklahoma Corporation Commission Telephone Rules, OAC 165:55) pp. 10-11. The Wyoming and Florida commissions have indicated their support for such an approach. *See* Wyoming Commission comments at 27 (supporting uniform use of TSLRIC costing methods so long as details left to states); *see also* Florida Commission comments at 26 (TSLRIC may be appropriate to set cost standard for a price floor).

shared facilities and operations. Those costs shall be attributed to specific elements to the greatest extent possible.[1688] For example, the costs of conduits shared by both transport and local loops, and the costs of central office facilities shared by both local switching and tandem switching, shall be attributed to specific elements in reasonable proportions. More broadly, certain shared costs that have conventionally been treated as common costs (or overheads) shall be attributed directly to the individual elements to the greatest extent possible. The forward-looking costs directly attributable to local loops, for example, shall include not only the cost of the installed copper wire and telephone poles but also the cost of payroll and other back office operations relating to the line technicians, in addition to other attributable costs.

683. Forward-looking cost methodologies, like TELRIC, are intended to consider the costs that a carrier would incur in the future. Thus, a question arises whether costs should be computed based on the least-cost, most efficient network configuration and technology currently available, or whether forward-looking cost should be computed based on incumbent LECs' existing network infrastructures, taking into account changes in depreciation and inflation. The record indicates three general approaches to this issue. Under the first approach, the forward-looking economic cost for interconnection and unbundled elements would be based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry. Prices based on the least-cost, most efficient network design and technology replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represent the least-cost systems available for purchase. This approach, however, may discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network.

684. Under the second approach, the cost of interconnection and unbundled network elements would be based on existing network design and technology that are currently in operation.[1689] Because this approach is not based on a hypothetical network in the short run, incumbent LECs could recover costs based on their existing operations, and prices for interconnection and unbundled elements that reflect inefficient or obsolete network design and technology. This is essentially an embedded cost methodology.

685. Under the third approach, prices for interconnection and access to unbundled elements would be developed from a forward-looking economic cost methodology based on the most efficient technology deployed in the incumbent LEC's current wire center locations.

[1688] *Compare Telephone Company-Cable Television Cross-Ownership Rules*, CC Docket No. 87-266, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 345-46 (1994).

[1689] *See, e.g.*, BellSouth reply at 37; Roseville Tel. reply at 8; USTA reply at 18-19.

This approach mitigates incumbent LECs' concerns that a forward-looking pricing methodology ignores existing network design, while basing prices on efficient, new technology that is compatible with the existing infrastructure. This benchmark of forward-looking cost and existing network design most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants. Moreover, this approach encourages facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC. We, therefore, conclude that the forward-looking pricing methodology for interconnection and unbundled network elements should be based on costs that assume that wire centers will be placed at the incumbent LEC's current wire center locations, but that the reconstructed local network will employ the most efficient technology for reasonably foreseeable capacity requirements.

686. We agree with USTA, Bell Atlantic, and BellSouth that, as a theoretical matter, the combination of significant sunk investment, declining technology costs, and competitive entry may increase the depreciation costs and cost of capital of incumbent LECs. We do not agree, however, that TSLRIC does not or cannot account for risks that an incumbent LEC incurs because it has sunk investments in facilities. On the contrary, properly designed depreciation schedules should account for expected declines in the value of capital goods. Both AT&T and MCI appear to agree with this proposition.[1690] For example, AT&T states, "[i]n order to estimate TSLRIC, one must perform a discounted cash flow analysis of the future costs associated with the decision to invest . . . . One-time costs associated with the acquisition of capital goods are amortized over the economic life of the assets using the user cost of capital . . . , which requires accounting for both expected capital good price changes and economic depreciation."[1691] Moreover, we are confident that parties to an arbitration with TELRIC studies can propose specific depreciation rate adjustments that reflect expected asset values over time.

687. As noted, we also agree that, as a matter of theory, an increase in risk due to entry into the market for local exchange service can increase a LEC's cost of capital. We believe that this increased risk can be partially mitigated, however, by offering term discounts, since long-term contracts can minimize the risk of stranded investment. In addition, growth in overall market demand can increase the potential of the incumbent LEC to use some of its

[1690] *See* Letter from Leonard S. Sawicki, Director, FCC Affairs, MCI Telecommunications Corp. to William F. Caton, Acting Secretary, FCC, July 24, 1996 at Attachment (Depreciation and Capital Recovery Issues: A Response to Professor Hausman), pp.1-3; *see also* Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman).

[1691] Letter from Richard N. Clarke, AT&T, to William F. Caton, Acting Secretary, FCC, July 19, 1996 at Attachment (Capital Recovery Issues in TSLRIC Pricing: Response to Professor Jerry A. Hausman), p.8.

displaced facilities for other purposes. Overall, we think that these factors can and should be captured in any LRIC model and therefore we do not agree that this requires a departure from the general principle of forward-looking cost-based pricing for network elements.

688. We are not persuaded by USTA's argument that forward looking methodologies fail to adjust the cost of capital to reflect the risks associated with irreversible investments and that they are "biased downward by a factor of three." First, USTA's argument unrealistically assumes that competitive entry would be instantaneous. The more reasonable assumption of entry occurring over time will reduce the costs associated with sunk investment. Second, we find it unlikely that investment in communications equipment is entirely irreversible or that such equipment would become valueless once facilities-based competition begins. In a growing market, there most likely would be demand for at least some embedded telecommunications equipment, which would therefore retain its value. Third, contractual arrangements between the new entrant and the incumbent that specifically address USTA's concerns and protect incumbent's investments during transition can be established.

689. Finally we are not persuaded that the use by firms of hurdle rates that exceed the market cost of capital is convincing evidence that sunk investments significantly increase a firm's cost of capital. An alternative explanation for this phenomenon is that the process that firms use to choose among investment projects results in overestimates of their returns. Firms therefore use hurdle rates in excess of the market cost of capital to account for these overestimates.[1692]

690. *Summary of TELRIC Methodology.* The following summarizes our conclusions regarding setting prices of interconnection and access to unbundled network elements based on the TELRIC methodology for such elements. The increment that forms the basis for a TELRIC study shall be the entire quantity of the network element provided. As we have previously stated, all costs associated with the providing the element shall be included in the incremental cost. Only forward-looking, incremental costs shall be included in a TELRIC study. Costs must be based on the incumbent LEC's existing wire center locations and most efficient technology available.

691. Any function necessary to produce a network element must have an associated cost. The study must explain with specificity why and how specific functions are necessary to provide network elements and how the associated costs were developed. Only those costs that are incurred in the provision of the network elements in the long run shall be directly

[1692] *See* Richard Thaler, *The Winner's Curse*, 2 J. Econ. Perspectives 201 (1988); Keith Brown, *Note on the Apparent Bias of Net Revenue Estimates for Capital Investment Projects*, 29 J. Fin. 1215-16 (1974); Daniel Kahneman and Daniel Lovallo, *Timid Choices, Bold Forecasts*, 39 Management Science 17, 28 (1993). In addition, we note that Hausman's arguments that TSLRIC method underestimate the true cost of an element apply only to the capital expense associated with an element and not to the operating expense.

attributable to those elements. Costs must be attributed on a cost-causative basis. Costs are causally-related to the network element being provided if the costs are incurred as a direct result of providing the network elements, or can be avoided, in the long run, when the company ceases to provide them. Thus, for example, the forward-looking costs of capital (debt and equity) needed to support investments required to produce a given element shall be included in the forward-looking direct cost of that element. Directly attributable costs shall include costs such as certain administrative expenses, which have traditionally been viewed as common costs, if these costs vary with the provision of network elements. Retailing costs, such as marketing or consumer billing costs associated with retail services, are not attributable to the production of network elements that are offered to interconnecting carriers and must not be included in the forward-looking direct cost of an element.

692. In a TELRIC methodology, the "long run" used shall be a period long enough that all costs are treated as variable and avoidable.[1693] This "long run" approach ensures that rates recover not only the operating costs that vary in the short run, but also fixed investment costs that, while not variable in the short term, are necessary inputs directly attributable to providing the element.

693. States may review a TELRIC economic cost study in the context of a particular arbitration proceeding, or they may conduct such studies in a rulemaking and apply the results in various arbitrations involving incumbent LECs. In the latter case, states must replace any interim rates[1694] set in arbitration proceedings with the permanent rate resulting from the separate rulemaking. This permanent rate will take effect at or about the time of the conclusion of the separate rulemaking and will apply from that time forward.

694. *Forward-Looking Common Costs.* Certain common costs are incurred in the provision of network elements. As discussed above, some of these costs are common to only a subset of the elements or services provided by incumbent LECs. Such costs shall be allocated to that subset, and should then be allocated among the individual elements or services in that subset, to the greatest possible extent. For example, shared maintenance facilities and vehicles should be allocated only to the elements that benefit from those facilities and vehicles. Common costs also include costs incurred by the firm's operations as a whole, that are common to all services and elements (*e.g.*, salaries of executives involved in overseeing all activities of the business), although for the purpose of pricing interconnection and access to unbundled elements, which are intermediate products offered to competing carriers, the relevant common costs do not include billing, marketing, and other costs

[1693] *See* 1 Alfred E. Kahn *The Economics of Regulation: Principles and Institutions* 70-71 (1988).

[1694] *See infra*, Section VII.C., discussing default proxy price ceilings and ranges.

attributable to the provision of retail service.[1695] Given these common costs, setting the price of each discrete network element based solely on the forward-looking incremental costs directly attributable to the production of individual elements will not recover the total forward-looking costs of operating the wholesale network.[1696] Because forward-looking common costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements.

695. The incumbent LECs generally argue that common costs are quite significant,[1697] while several other parties maintain that these amounts are minimal.[1698] Because the unbundled network elements correspond, to a great extent, to discrete network facilities, and have different operating characteristics, we expect that common costs should be smaller than the common costs associated with the long-run incremental cost of a service. We expect that many facility costs that may be common with respect to the individual services provided by the facilities can be directly attributed to the facilities when offered as unbundled network elements. Moreover, defining the network elements at a relatively high level of aggregation, as we have done,[1699] should also reduce the magnitude of the common costs. A properly conducted TELRIC methodology will attribute costs to specific elements to the greatest possible extent, which will reduce the common costs. Nevertheless, there will remain some common costs that must be allocated among network elements and interconnection services. For example, at the sub-element level of study (*e.g.*, identifying the respective costs of 2-wire loops, 4-wire loops, ISDN loops, and so on), common costs may be a significant proportion of all the costs that must be recovered from sub-elements. Given the likely asymmetry of information regarding network costs, we conclude that, in the arbitration process, incumbent LECs shall have the burden to prove the specific nature and magnitude of these forward-looking common costs.

696. We conclude that forward-looking common costs shall be allocated among elements and services in a reasonable manner, consistent with the pro-competitive goals of the

[1695] *See infra*, Section VIII.B., describing "avoided costs" in the resale context.

[1696] *See, e.g.*, AT&T comments at 61-66; Teleport comments at 47-48.

[1697] *See, e.g.*, PacTel reply at 27-28; *see also* Cincinnati Bell reply at 10; USTA comments at Attachment 1 (Affidavit of Jerry A. Hausman), p.4 n.1.

[1698] *See, e.g.*, Competition Policy Institute comments at 19; MCI comments at 66; Texas Public Utility Counsel comments at 24.

[1699] *See supra*, Section V., discussing unbundling requirements.

1996 Act. One reasonable allocation method would be to allocate common costs using a fixed allocator, such as a percentage markup over the directly attributable forward-looking costs. We conclude that a second reasonable allocation method would allocate only a relatively small share of common costs to certain critical network elements, such as the local loop and collocation, that are most difficult for entrants to replicate promptly (*i.e.*, bottleneck facilities). Allocation of common costs on this basis ensures that the prices of network elements that are least likely to be subject to competition are not artificially inflated by a large allocation of common costs. On the other hand, certain other allocation methods would not be reasonable. For example, we conclude that an allocation methodology that relies exclusively on allocating common costs in inverse proportion to the sensitivity of demand for various network elements and services may not be used.[1700] We conclude that such an allocation could unreasonably limit the extent of entry into local exchange markets by allocating more costs to, and thus raising the prices of, the most critical bottleneck inputs, the demand for which tends to be relatively inelastic. Such an allocation of these costs would undermine the pro-competitive objectives of the 1996 Act.

697. We believe that our treatment of forward-looking common costs will minimize regulatory burdens and economic impact for all parties involved in arbitration of agreements for interconnection and access to unbundled elements, and will advance the 1996 Act's pro-competitive objectives for local exchange and exchange access markets.[1701] In our decisionmaking, we have considered the economic impact of our rules in this section on small incumbent LECs. For example, although opposed to the use of a forward-looking, economic cost methodology, small incumbent LECs favor the recovery of joint and common costs in the event the Commission adopts forward-looking cost methodology. We are adopting such an approach. Moreover, the cost-based pricing methodology that we are adopting is designed to permit incumbent LECs to recover their economic costs of providing interconnection and unbundled elements, which may minimize the economic impact of our decisions on incumbent LECs, including small incumbent LECs. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1702]

[1700] *See* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 Econ. J. 47 (1927); *see generally* Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* 115-40 (1992) (discussing efficiency properties of Ramsey prices); Bridger M. Mitchell & Ingo Vogelsang, *Telecommunications Pricing: Theory and Practice* 43-61 (1991). The sensitivity of demand is measured by the elasticity of demand, which is defined as the percentage change in the quantity of a service demanded for a one per cent change in price.

[1701] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1702] 47 U.S.C. § 251(f).

698. We further conclude that, for the aggregate of all unbundled network elements, incumbent LECs must be given a reasonable opportunity to recover their forward-looking common costs attributable to operating the wholesale network. In no instance should prices exceed the stand-alone cost for a specific element, and in most cases they should be below stand-alone costs. Stand-alone costs are defined as the forward-looking cost that an efficient entrant would incur in providing a given element or any combination of elements. No price higher than stand-alone cost could be sustained in a market from which entry barriers were completely absent. Where there are few common costs, there is likely to be only a minimal difference between the forward-looking costs that are directly attributable to the particular element, which excludes these costs, and stand-alone cost, which includes all of them. Network elements should not, however, be priced at levels that would enable the incumbent LEC to recover the same common costs multiple times from different elements. Any multiple recovery would be unreasonable and thus in violation of the statutory standard. Further, we note that the sum of the direct costs and the forward-looking common costs of all elements will likely differ from the incumbent LEC's historical, fully distributed costs.

699. *Reasonable Return on Investment and "Profit."* Section 252(d)(1) states that rates for interconnection and access to unbundled elements "may include a reasonable profit."[1703] We find that the TELRIC pricing methodology we are adopting provides for such a reasonable profit and thus no additional profit is justified under the statutory language. We note there are two types of profit. First, in plain English, profit is defined as "the excess of returns over expenditure in a transaction or a series of transactions."[1704] This is also known as a "normal" profit, which is the total revenue required to cover all of the costs of a firm, including its opportunity costs.[1705] Second, there is "economic" profit, which is any return in excess of normal profit.[1706] Thus, for example, if the normal return in an industry is 10 percent and a firm earns a return of 14 percent, the economic profit for that firm is 4 percent. Economic is also referred to as "supranormal" profit. We conclude that the definition of "normal" profit is embodied in "reasonable profit" under Section 252(d)(1).

700. The concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements. This forward-looking cost of capital is equal to a normal profit. We conclude that allowing greater than normal profits

---

[1703] 47 U.S.C. § 252(d)(1).

[1704] *Webster's New Collegiate Dictionary* 931 (10th ed. 1994).

[1705] *See* David W. Pearce, *The MIT Dictionary of Modern Economics* (1994) at 310.

[1706] *Id.* at 415.

would not be "reasonable" under sections 251(c) and 252(d)(1).[1707] Thus, contrary to the arguments put forth by several incumbent LECs, we find that adding an additional measure of profit to the risk-adjusted cost of capital[1708] in setting the prices for interconnection and access to unbundled elements would violate the requirements of sections 251(c) and 252(d)(1) of the 1996 Act.

701. Possible accounting losses from the sale of interconnection and unbundled network elements using a reasonable forward-looking cost-based methodology do not necessarily indicate that incumbent LECs are being denied a "reasonable profit" under the statute. The use of a forward-looking, economic, cost-based pricing methodology, including a reasonable allocation of legitimate joint and common costs, will permit incumbent LECs the opportunity to earn a reasonable return on their investment in network elements. Finally, contrary to PacTel's argument, and as discussed below in detail, we conclude that our forward-looking cost-based pricing methodology is consistent with the Fifth Amendment and is not confiscatory.

[1707] We note that our interpretation is consistent with existing Supreme Court precedent concerning what constitutes a reasonable rate of return for a regulated public utility. For example, in *Bluefield Water Works*, the Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.

Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923). Similarly, in *FPC v. Hope Natural Gas*, the Court stated:

> . . . it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock . . . By that standard the return to the equity owner should be commensurate with risks on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1994) (*Hope Natural Gas*). *Cf.*, Charles F. Phillips, Jr., *The Economics of Regulation* 260 (Rev. ed. 1965) (". . . a regulated company must be afforded the opportunity not only of assuring its financial integrity so that it can maintain its credit standing and attract additional capital as needed, but also for earnings comparable to those of other companies having corresponding risks.").

[1708] *See supra*, this Section, for a discussion of risk-adjusted cost of capital.

702. Based on the current record, we conclude that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate. These elements generally are bottleneck, monopoly services that do not now face significant competition. We recognize that incumbent LECs are likely to face increased risks given the overall increases in competition in this industry, which generally might warrant an increased cost of capital, but note that, earlier this year, we instituted a preliminary inquiry as to whether the currently authorized federal 11.25 percent rate of return is too high given the current marketplace cost of equity and debt.[1709] On the basis of the current record, we decline to engage in a time-consuming examination to determine a new rate of return, which may well require a detailed proceeding. States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted, without that commission conducting a "rate-of-return or other rate based proceeding."[1710] We note that the risk-adjusted cost of capital need not be uniform for all elements. We intend to re-examine the issue of the appropriate risk-adjusted cost of capital on an ongoing basis, particularly in light of the state commissions' experiences in addressing this issue in specific situations.

703. We disagree with the conclusion that, when there are mostly sunk costs, forward-looking economic costs should not be the basis for pricing interconnection elements. The TELRIC of an element has three components, the operating expenses, the depreciation cost,[1711] and the appropriate risk-adjusted cost of capital. We conclude that an appropriate calculation of TELRIC will include a depreciation rate that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor. Thus, even in the presence of sunk costs, TELRIC-based prices are an appropriate pricing methodology.

[1709] *See Common Carrier Bureau Sets Pleading Schedule in Preliminary Rate of Return Inquiry*, Public Notice, 11 FCC Rcd 3651 (Com. Car. Bur. 1996).

[1710] 47 U.S.C. § 252(d)(1)(A)(i).

[1711] Depreciation is the method of recognizing as an expense the cost of a capital investment. Properly calculated economic depreciation is a periodic reduction in the book value of an asset that makes the book value equal to its economic or market value.

(b) Cost Measures Not Included in Forward-Looking Cost Methodology

704. *Embedded Costs.* We read section 252(d)(1)(A)(i) to prohibit states from conducting traditional rate-of-return or other rate-based proceedings to determine rates for interconnection and access to unbundled network elements. We find that the parenthetical, "(determined without reference to a rate-of-return or other rate-based proceeding)," [1712] does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the cost of interconnection and unbundled network elements. The legislative history demonstrates that Congress was eager to set in motion expeditiously the development of local competition and intended to avoid imposing the costs and administrative burdens associated with a traditional rate case. Prior to the joint conference, the Senate version of the 1996 Act contained the parenthetical language. [1713] In addition, the Senate version of the 1996 Act eliminated rate-of-return regulation, [1714] as did the House version. [1715] Conferees removed the provisions eliminating rate-of-return regulation, but retained the parenthetical.

705. Section 252(d)(1)(A)(i) does not specify whether historical or embedded costs should be considered or whether only forward-looking costs should be considered in setting arbitrated rates. We are not persuaded by incumbent LEC arguments that prices for interconnection and unbundled network elements must or should include any difference between the embedded costs they have incurred to provide those elements and their current economic costs. Neither a methodology that establishes the prices for interconnection and access to network elements directly on the costs reflected in the regulated books of account, nor a price based on forward looking costs plus an additional amount reflecting embedded costs, would be consistent with the approach we are adopting. The substantial weight of economic commentary in the record suggests that an "embedded cost"-based pricing methodology would be pro-competitor -- in this

[1712] 47 U.S.C. § 252(d)(1)(A)(i).

[1713] S. 652, 104th Cong., 1st Sess. § 251(d)(6)(A) (1995) ("the charge (A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the unbundled element . . . .").

[1714] *Id.* at § 301(a)(3) ("Rate of Return Regulation Eliminated -- (A) In instituting the price flexibility required under paragraph (1) the Commission and the States shall establish alternative forms of regulation for Tier 1 telecommunications carriers that do not include regulation of the rate of return earned by such carrier . . . .").

[1715] H.R. 1555, 104th Cong., 1st Sess. § 248(b) (1995) ("Abolition of Rate-of-Return Regulation -- Notwithstanding any other provision of law, to the extent that a carrier has complied with sections 242 and 244 of this part, the Commission, with respect to rates for interstate or foreign communications, and State commissions, with respect to rates for intrastate communications, shall not require rate-of-return regulation.").

case the incumbent LEC -- rather than pro-competition. [1716] We therefore decline to adopt embedded costs as the appropriate basis of setting prices for interconnection and access to unbundled elements. Rather, we reiterate that the prices for the interconnection and network elements critical to the development of a competitive local exchange should be based on the pro-competition, forward-looking, economic costs of those elements, which may be higher or lower than historical embedded costs. Such pricing policies will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act, which should minimize the regulatory burdens and economic impact of our decisions on small entities. [1717]

706. Incumbent LECs contend generally that, in order to ensure they will recover their total investment costs and earn a profit, they must recover embedded costs. These costs, they argue, were incurred under federal and regulatory oversight and therefore should be recoverable. [1718] We are not convinced by the incumbent LECs' principal arguments for recognizing embedded cost in setting section 251 pricing rules. Even if the incumbent LECs' contention is correct, increasing the rates for interconnection and unbundled elements offered to competitors would interfere with the development of efficient competition, and is not the proper remedy for any past under-depreciation. Moreover, contrary to assertions by some incumbent LECs, regulation does not and should not guarantee full recovery of their embedded costs. Such a guarantee would exceed the assurances that we or the states have provided in the past. [1719] We have considered the economic impact of precluding recovery of small incumbent LECs' embedded costs. [1720] We do not believe that basing the prices of interconnection and unbundled elements on an incumbent LEC's embedded costs would advance the pro-competitive goals of the statute. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under

[1716] *See, e.g.*, Ad Hoc Telecommunications Users' Committee reply at Appendix A (Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market), p.4; ALTS comments at Attachment B (Competitive Pricing of Interconnection, Unbundled Elements, and Collocation), pp.28-29; AT&T reply at Appendix B (Reply Affidavit of William J. Baumol, Janusz A. Ordover, and Robert D. Willig), pp.3-5; Competition Policy Institute comments at 18-19; DJ comments at 30-31.

[1717] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1718] *See, e.g.*, Ameritech reply at 31; BellSouth comments at 57; Lincoln Tel. comments at 16-17.

[1719] *See In the Matter of the Applications of Pacific Bell*, Order and Authorization, 10 FCC Rcd 12448, 12502-12503 (1995).

[1720] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

section 251(f)(2) of the 1996 Act.[1721]

707. We acknowledge that some incumbent LECs may have incurred certain embedded costs reasonably before the passage of the 1996 Act, based on different regulatory regimes. Some incumbent LECs may assert that they have made certain historical investments required by regulators that they have been denied a reasonable opportunity to recover in the past and that the incumbent LECs may no longer have a reasonable opportunity to recover in the new environment of the 1996 Act. The record before us, however, does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at economic costs. To the extent that any such residual consists of costs of meeting universal service obligations, the recovery of such costs can and should be considered in our ongoing universal service proceeding.[1722] To the extent a significant residual exists within the interstate jurisdiction that does not fall within the ambit of section 254, we intend that to address that issue in our upcoming proceeding on access reform.

708. *Opportunity Cost -- Efficient Component Pricing Rule.* A number of incumbent LECs advocate using the "efficient component pricing rule" (ECPR) to set the prices that incumbent LECs charge new entrants for inputs required to produce the same retail services the incumbent produces. Under the ECPR, the price of an input should be equal to the incremental cost of the input plus the opportunity cost that the incumbent carrier incurs when the new entrant provides the services instead of the incumbent. The opportunity cost, which is computed as revenues less all incremental costs, represents both profit and contribution to common costs of the incumbent, given the existing retail prices of the services being sold.

709. We conclude that ECPR is an improper method for setting prices of interconnection and unbundled network elements because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based. Moreover, the ECPR does not provide any mechanism for moving prices towards competitive levels; it simply takes prices as given. The record indicates that both incumbents and new entrants agree that retail prices are not based on costs. Incumbents generally argue that local residential retail prices are below costs while new entrants contend that they exceed competitive levels.[1723] In either case, application of ECPR would result in input prices that would be either higher or lower than those which would be generated in a competitive market and would not lead to efficient retail pricing.

710. In markets where retail prices exceed competitive levels, entry would take place if

[1721] 47 U.S.C. § 251(f).

[1722] *See Universal Service* NPRM at para. 32.

[1723] *See, e.g.*, Ameritech comments at 62.

network element prices were set at efficient competitive levels. The ECPR, however, will serve to discourage competition in these very markets because it relies on the prevailing retail price in setting the price which new entrants pay the incumbent for inputs. While ECPR establishes conditions for efficient entry given existing retail prices, as its advocates contend, the ECPR provides no mechanism that will force retail prices to their competitive levels. We do not believe that Congress envisioned a pricing methodology for interconnection and network elelments that would insulate incumbent LECs' retail prices from competition. Instead, Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore, we reject the use of ECPR for establishing prices for interconnection and unbundled elements.

711. As discussed above, the record in this docket shows that end user prices are not cost-based. In *Open Video Systems*, in contrast, we did not find that there would be a problem with the determination of end user prices.[1724] We concluded that "[u]se of [an ECPR] approach is appropriate in circumstances where the pricing is applicable [sic] to a new market entrant (the open video system operator) that will face competition from an existing incumbent provider (the incumbent cable operator), as opposed to circumstances where the pricing is used to establish a rate for an essential input service that is charged to a competing new entrant by an incumbent provider."[1725] In addition, in *Open Video Systems*, we concluded that the ECPR is appropriate because it encourages entry for open video system operators and also enhances the availability of carriage for unaffiliated programmers.[1726] The ECPR generally protects the provider's profits and provides opportunities for third parties to use the provider's inputs. The ECPR does not provide a mechanism to drive retail prices to competitive levels, however. In *Open Video Systems*, we wanted to encourage entry by open video system providers and to encourage them to have incentives to open their systems to unaffiliated programmers. Here, our goal is to ensure that competition between providers, including third party providers using interconnection and unbundled elements, will drive prices toward competitive levels and thus use of the ECPR is inappropriate.

712. *Universal Service Subsidies.* We conclude that funding for any universal service mechanisms adopted in the universal service proceeding may not be included in the rates for interconnection, network elements, and access to network elements that are arbitrated by the states under sections 251 and 252. Sections 254(d) and 254(e) of the 1996 Act mandate that universal service support be recovered in an equitable and nondiscriminatory manner from all providers of

[1724] *Implementation of Section 302 of the Telecommunications Act of 1996 -- Open Video Systems*, CS Docket No. 96-46, Second Report and Order, FCC 96-249 (rel. June 3, 1996) (*Open Video Systems*).

[1725] *Id.* at 127.

[1726] *Id.*

telecommunications services.[1727] We conclude that permitting states to include such costs in rates arbitrated under sections 251 and 252 would violate that requirement by requiring carriers to pay specified portions of such costs solely because they are purchasing services and elements under section 251. Section 252(d)(1) requires that rates for interconnection, network elements, and access to network elements reflect the costs of providing those network elements, not the costs of supporting universal service.

713. Section 254(f) provides that a state may adopt equitable, nondiscriminatory, specific, and predictable mechanisms to advance universal service within that state.[1728] If a state collects universal service funding in rates for elements and services pursuant to sections 251 and 252, it will be imposing non-cost based charges in those rates. Including non-cost based charges in the rates for interconnection and unbundled elements is inconsistent with our rules implementing sections 251 and 252 which require that these rates be cost-based. It is also inconsistent with the requirement of section 254(f) that telecommunications carriers contribute to state universal service on a nondiscriminatory basis, because telecommunications carriers requesting interconnection or access to unbundled network elements will be required to make contributions to universal service support through such surcharges.[1729] States may not, therefore, include universal service support funding in the rates for elements and services pursuant to sections 251 and 252, nor may they implement mechanisms that have the same effect. For example, states may not fund universal service support by imposing higher rates for interconnection, unbundled elements, or transport and termination on carriers that offer service to different types of customers or different geographic areas. To the extent that New York's "pay or play" system funds universal service in this manner, it violates sections 251, 252, and 254 of the 1996 Act. Nothing in the 1996 Act or in this Order, however, precludes a state from adopting a universal service funding mechanism, whether interim or otherwise, if such funds are collected in accordance with section 254(f) on an "equitable and nondiscriminatory basis" through "specific, predictable, and sufficient mechanisms that do not rely on or burden Federal universal service support mechanisms."[1730]

714. Our decision here does not exempt carriers purchasing elements or services under section 251 from contributing to (or possibly receiving) universal service support. Rather, the recovery of universal service support costs from telecommunications carriers, including carriers requesting unbundled network elements, will be governed by section 254 of the 1996 Act.

[1727] Joint Explanatory Statement at 131 ("In keeping with the conferees' intent that universal service support should be clearly identified, [section 254(e)] states that such support should be made explicit . . .").

[1728] 47 U.S.C. § 254(f).

[1729] *See infra*, Section VII.D.3., discussing discrimination.

[1730] 47 U.S.C. § 254(f).

Federal universal service support mechanisms will be determined by our decisions reached in CC Docket 96-45, based on the recommendations of the Federal/State Universal Service Joint Board, and states may adopt additional universal service support mechanisms consistent with section 254(f).

715. We are mindful that the requirements of the 1996 Act may be disruptive to existing state universal service support mechanisms during the period commencing with this order and continuing until we complete our universal service proceeding to implement section 254. As discussed in the subsection immediately below, we permit incumbent LECs to continue to recover certain non-cost-based interstate access charge revenues for a limited period of time, largely because of concerns about possible deleterious impacts on universal service. We also authorize incumbent LECs, for a similar limited period of time, to continue to recover explicit intrastate universal service subsidy revenues based on intrastate access charges. This mechanism minimizes any possibility that implementation of sections 251 and 252 will unduly harm universal service during the interim period prior to completion of our universal service and access reform proceedings. Because we conclude this action should adequately provide for the continuation of a portion of existing subsidy flows during a transition period until completion of our proceeding implementing section 254, we decline to permit any additional funding of universal service support through rates for interconnection, unbundled elements, and transport and termination during the interim period.

716. *Interim Application of Access Charges to Purchasers of Unbundled Local Switching Element.* In the introduction of this Order, we emphasize that implementation of section 251 of the 1996 Act is integrally related to both universal service reform as required under section 254, and to reform of the interstate access charge system.[1731] In order to achieve pro-competitive, deregulatory markets for all telecommunications services, we must create a new system of funding universal service that is specific, explicit, predictable, sufficient, and competitively neutral. We also must move access charges to more cost-based and economically efficient levels. We intend to fulfill both of these goals in the coming months, by completing our pending universal service proceeding to implement section 254 by our statutory deadline of May 1997, and by addressing access charge issues in an upcoming access reform proceeding. The 1996 Act, however, requires us to adopt rules implementing section 251 by August 1996. We are concerned that implementation of the requirements of section 251 now, without taking into account the effects of the new rules on our existing access charge and universal service regimes, may have significant, immediate, adverse effects that were neither intended nor foreseen by Congress.

717. Specifically, as we conclude above, the 1996 Act permits telecommunications carriers that purchase access to unbundled network elements from incumbent LECs to use those elements to provide telecommunications services, including the origination and termination of interstate calls. Without further action on our part, section 251 would allow entrants to use those

---

[1731] *See supra*, Section I.B.

unbundled network facilities to provide access services to customers they win from incumbent LECs, without having to pay access charges to the incumbent LECs. This result would be consistent with the long term outcome in a competitive market. In the short term, however, while other aspects of our regulatory regime are in the process of being reformed, such a change may have detrimental consequences.

718. The access charge system includes non-cost-based components and elements that at least in part may represent subsidies, such as the carrier common line charge (CCLC) and the transport interconnection charge (TIC). The CCLC recovers part of the allocated interstate costs for incumbent LECs to provide local loops to end users. In the universal service NPRM, we observed that the CCLC may result in higher-volume toll users paying rates that exceed cost, and some customers paying rates that are below cost. We sought comment on whether that subsidy should be continued, and on whether and how it should be restructured.[1732] The nature of most of the revenues recovered through the TIC is unclear and subject to dispute, although a portion of the TIC is associated with certain costs related to particular transport facilities. Although the TIC was not created to subsidize local rates, some parties have argued in the *Transport* proceeding and elsewhere that some portion of the revenues now recovered through the TIC may be misallocated local loop or intrastate costs that operate to support universal service.[1733] In the forthcoming access reform proceeding, we intend to consider the appropriate disposition of the TIC, including the development of cost-based transport rates as directed by the United States Court of Appeals for the District of Columbia Circuit in *Competitive Telecommunications Association v. FCC* (*CompTel v. FCC*).[1734]

719. Without a temporary mechanism such as the one we adopt below, the implementation of section 251 would permit competitive local service providers that also provide interstate long-distance service to avoid totally the CCLC and the TIC, which in part represent contributions toward universal service, by serving their local customers solely through the use of unbundled network elements rather than through resale. We believe that allowing such a result before we have reformed our universal service and access charge regimes would be undesirable as a matter of both economics and policy, because carrier decisions about how to interconnect with incumbent LECs would be driven by regulatory distortions in our access charge rules and our universal service scheme, rather than the unfettered operation of a competitive market. Because

[1732] *Universal Service* NPRM at paras. 113-14.

[1733] *Transport Rate Structure and Pricing*, CC Docket No. 91-213, Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7065-7066 (1992) (*First Transport Order*). *Cf.* Letter from Bruce K. Cox, Government Affairs Director, AT&T, to William F. Caton, Acting Secretary, FCC, September 7, 1995 (filed in CC Docket No. 91-213) (suggesting that TIC revenues not allocable to specific transport facilities may represent misallocated common line costs).

[1734] *Competitive Telecommunications Association v. FCC*, No. 96-1168 (D.C. Cir. July 5, 1996).

of our desire to err on the side of caution where universal service may be implicated, we conclude that some action is needed during the interim period before we complete our access reform and universal service proceedings.

720. We conclude that we should establish a temporary transitional mechanism to help complete all of the steps toward the pro-competitive goal of the 1996 Act, including the implementation of a new, competitively-neutral system to fund universal service and a comprehensive review of our system of interstate access charges. Therefore, for a limited period of time, incumbent LECs may recover from interconnecting carriers the CCLC and a charge equal to 75 percent of the TIC for all interstate minutes traversing the incumbent LECs' local switches for which the interconnecting carriers pay unbundled local switching element charges. Incumbent LECs may recover these charges only until the earliest of: (1) June 30, 1997; (2) the effective date of final decisions by the Commission in both the universal service and access reform proceedings; or (3) if the incumbent LEC is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. The end date for BOCs that are authorized to offer interLATA service shall apply only to the recovery of access charges in those states in which the BOC is authorized to offer such service.

721. We tentatively concluded in the NPRM that purchasers of unbundled network elements should not be required to pay access charges. We reaffirm our conclusion above in our discussion of unbundled network elements that nothing on the face of sections 251(c)(3) and 252(d)(1) compels telecommunications carriers that use unbundled elements to pay these charges, nor limits these carriers' ability to use unbundled elements to originate or terminate interstate calls, and that payment of rates based on TELRIC plus a reasonable allocation of common costs, pursuant to section 251(d)(1), represents full compensation to the incumbent LEC for use of the network elements that telecommunications carriers purchase. Because of the unique situation described in the preceding paragraphs, however, we conclude, contrary to our proposal in the NPRM, that during a time-limited period, interconnecting carriers should not be able to use unbundled elements to avoid access charges in all cases. As detailed below, this temporary mechanism will apply only to carriers that purchase the local switch as an unbundled network element, and use that element to originate or terminate interstate traffic.[1735] We are applying these transitional charges to the unbundled local switching element, rather than to any other network elements, because such an approach is most closely analogous to the manner in which the CCLC and TIC are recovered in the interstate access regime. Currently, the CCLC and TIC apply to interstate switched access minutes that traverse incumbent LECs' local switches. Applying the CCLC and 75 percent of the TIC to the unbundled local switching element is consistent with our goal of minimizing disruptions while we reform our universal service system and consider changes to our access charge mechanisms. Moreover, the CCLC and the TIC are

[1735] As discussed *infra*, carriers that choose to enter a local market through resale of an incumbent LEC's intrastate local exchange service will pay interstate and intrastate access charges to originate and terminate toll traffic for end user customers that purchase that resold local exchange service.

recovered on a per-minute basis, and the local switch is the primary point at which incumbent LECs are capable of recording interstate minutes for traffic associated with end user customers of requesting carriers.

722. We have crafted this short-term continuation of certain access charge revenue flows to minimize the possibility that incumbent LECs will be able to "double recover" through access charges the facility costs that new entrants have already paid to purchase unbundled elements. For that reason, we do not permit incumbent LECs to assess on purchasers of the unbundled local switching element any interstate access charges other than the CCLC and 75 percent of the TIC. The other access charges are all designed to recover the cost of particular facilities involved in the provision of interstate access services, such as local switching, dedicated interoffice transport circuits, and tandem switching. Imposition of these facility-based access charges in addition to the cost-based charges for comparable network elements established under Section 252 could result in double recovery. The mechanism we establish will ensure that incentives created by non-cost-based elements of access charges do not result in harmful consequences prior to completion of access reform and our universal service proceeding. Imposition of additional access charges is therefore not necessary. We note that this mechanism serves to minimize the potentially disruptive effects of our decisions on incumbent LECs, including small incumbent LECs.[1736]

723. For the same reason, we permit incumbent LECs to recover only 75 percent of the TIC. Some portion of the TIC recovers revenues associated with specific transport facilities. To the extent that these costs can be identified clearly, they should not be imposed on new entrants through the TIC. Incumbent LECs will be fully compensated for any transport facilities that new entrants purchase from them through the unbundled element rates states establish under 252(d)(1), which, as we have stated, must be based on economic cost rather than access charges. In our interim transport rate restructuring, we explicitly set the initial tandem switching rate at 20 percent of the interstate revenue requirement, with the remainder included in the TIC.[1737] In addition, certain costs of upgrading incumbent LEC networks to support SS7 signaling were allocated to transport through then-existing separations procedures. In our interim transport rate restructuring, we did not create any facility-based charges to recover these costs,[1738] so the associated revenues presumably were incorporated into the TIC. There may also be other revenues associated with transport facilities that are recovered today through the TIC. While we are uncertain of the precise magnitude of these revenues, in our best judgment, based on the record in the *Transport* proceeding and other information before us, we find that it is likely that

[1736] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1737] *First Transport Order*, 7 FCC Rcd at 7019.

[1738] *First Transport Order*, 7 FCC Rcd at 7019.

these revenues approach, but probabiy do not exceed 25 percent of the TIC for most incumbent LECs. Thus, we believe that 25 percent is a conservative amount to exclude from the TIC to ensure that incumbent LECs do not double recover revenues associated with transport facilities from new entrants. Moreover, the Court in *CompTel v. FCC* remanded our *Transport* decision, in part, because of the inclusion of tandem switching revenues in the TIC rather than in the rate element for tandem switching. We find that excluding 25 percent of the TIC represents a reasonable exercise of our discretion to prevent revenues associated with the tandem switching revenue requirement from being recovered from purchasers or unbundled local switching.

724. We strongly emphasize that these charges will apply to purchasers of the unbundled switching element only for a very limited period, to avoid the possible harms that might arise if we were to ignore the effects on access charges and universal service of implementation of section 251. BOCs shall not be permitted to recover these revenues once they are authorized to offer in-region interLATA service, because at that time the potential loss of access charge revenues faced by a BOC most likely will be able to be offset by new revenues from interLATA services. Moreover, although we do not prejudge the conditions necessary to grant BOC petitions under section 271 to offer in-region interLATA service, we do decide that BOCs should not be able to charge the CCLC and the TIC, which are not based on forward-looking economic costs, to competitors that use unbundled elements under section 251 once they are authorized to provide in-region interLATA service. Only BOCs are subject to special restrictions in the 1996 Act to ensure that their entry into the in-region interLATA market does not have an adverse impact on competition. We conclude that this additional trigger date after which BOCs may not continue to receive access charges from purchasers of unbundled local switching is consistent with this Congressional design.

725. We have selected June 30, 1997 as an ultimate end date for this transitional mechanism to coincide with the effective date for LEC annual access tariffs, and because we believe it is imperative that this transitional requirement be limited in duration. We can conceive of no circumstances under which the requirement that certain entrants pay the CCLC or a portion of the TIC on calls carried over unbundled network elements would be extended further. The fact that access or universal service reform have not been completed by that date would not be a sufficient justification, nor would any actual or asserted harm to the financial status of the incumbent LECs. By June 30, 1997, the industry will have had sufficient time to plan for and adjust to potential revenue shifts that may result from competitive entry. Thus, the economic impact of our decision on competitive local service providers, including those that are small entities, should be minimized.[1739]

726. We believe that we have ample legal authority to implement this temporary transitional measure, and we find that this approach is consistent with the letter and spirit of the 1996 Act. We recognize that the CCLC and TIC have not been developed in accordance with the

[1739] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

pricing standards of section 252(d)(1), and that to comply with the 1996 Act, the rates that states establish for interconnection and unbundled network elements may not include non-cost-based amounts or subsidies. The 1934 and 1996 Acts do, however, give us legal authority to determine, for policy reasons, that users of LEC facilities should pay certain access charges for a period of time.[1740] Section 4(i) of the 1934 Act authorizes the Commission to "perform any and all acts . . . not inconsistent with this Act, as may be necessary in the execution of its functions."[1741] Given the extraordinary upheaval in the industry's structure set in motion by the 1996 Act, and the specific concerns described above, we believe that a temporary mechanism is necessary in order to ensure that the policy goals underlying the access charge system and the Communications Act itself are not undermined. Further, we believe section 251(g) of the 1996 Act lends support to our decision. As discussed above, section 251(g) does not require that incumbent LECs continue to receive access charge revenues when telecommunications carriers use unbundled incumbent LEC network elements to originate and terminate interstate traffic. That section does, however, provide evidence of Congressional recognition of the potential tension between existing interconnection obligations, such as access charges, and the new methods of interconnection mandated by section 251, and therefore supports our decision to create a limited-duration mechanism to address this tension.

727. The decision of the court in *CompTel v. FCC* to remand our decision to adopt the TIC is not inconsistent with this approach. The Court's concern stemmed, in part, from the inclusion of a portion of the interstate tandem switching revenue requirement in the TIC. We have excluded from the charges that purchasers of unbundled local switching must pay a percentage of the TIC that, at a minimum, includes these allocated tandem switching revenues from the transitional charges that incumbent LECs may assess on IXCs.[1742] Furthermore, the Court directed the Commission to develop a cost-based transport rate structure, or to explain why it chose not to do so.[1743] We intend to fulfill this obligation in the forthcoming access reform proceeding. The charge equal to 75 percent of the TIC will be applied only as an interim measure for a brief, clearly-identified period, until that restructuring of access charges is completed. The court expressly acknowledged that the 1996 Act would have implications for the

[1740] *See, e.g., New England Tel. and Tel. Co. v. FCC*, 826 F.2d 1101 (D.C. Cir 1987); *North American Telecommunications Association v. FCC*, 772 F.2d (7th Cir. 1085); *Lincoln Tel. and Tel. Co. v. FCC*, 659 F.2d (D.C. Cir. 1989).

[1741] 47 U.S.C. § 4(i).

[1742] As discussed above, we estimate that the tandem switching, SS7, and other costs associated with transport facilities now recovered through the TIC likely do not exceed 25% of the TIC for most incumbent LECs.

[1743] *Competitive Telecommunications Association v. FCC*, No. 96-1168 at 26-27.

access charge system.[1744] For the reasons described above, we conclude that these effects necessitate temporary application of a portion of the TIC to entrants that win end user customers from LECs, and that purchase the local switch as an unbundled element to originate and terminate interstate and intrastate toll traffic for such end users. In the access reform proceeding, we intend to determine the appropriate disposition for these revenues. Until we have had the opportunity to do so, however, we permit incumbent LECs to recover a transitional charge equal to 75 percent of the TIC under the limited circumstances described herein.

728. The interim mechanism we establish here differs from the waiver relief we have previously granted to NYNEX and Ameritech to permit them to recover certain interstate access charge revenues through "bulk billing" of revenues to all interstate switched access customers.[1745] Those orders responded to waiver requests filed prior to the passage of the 1996 Act. Our responsibility in those proceedings was to determine whether special circumstances existed, and whether the specific relief requested better served the public interest than continued application of our general rules. By constrast, the action we take today addresses industry-wide issues that arise from the new regime put into place by section 251 of the 1996 Act, which allows states to establish unbundled network element rates that recover the full unseparated cost of elements. Our response to the Ameritech and NYNEX waiver petitions does not, simply because those petitions also concerned access charge recovery, constrain our decision in this proceeding.

729. It would be unreasonable to provide such a transitional mechanism on the federal level, but to deny similar authority to the states. Therefore, states may continue existing explicit universal service support mechanisms based on intrastate access charges for an interim period of a similar brief, clearly-defined length. During that period, unless decided otherwise by the state, incumbent LECs may continue to recover such revenues from purchasers of unbundled local switching elements that use those elements to originate or terminate intrastate toll calls for end user customers they win from incumbent LECs. States may terminate these mechanisms at any time. We define mechanisms based on intrastate access charges as those mechanisms that require purchasers of intrastate access services from incumbent LECs to pay non-cost-based charges for those access services on the basis of their intrastate access minutes of use.

730. We do not intend, however, that such a transitional mechanism eviscerate the requirements of sections 252 and 254, which, as we have stated, prohibit funding of universal service subsidies through rates for interconnection and unbundled network elements. Mechanisms

[1744] *Id.* at 12-13.

[1745] *See The NYNEX Tel. Cos. Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment*, Memorandum Opinion and Order, 10 FCC Rcd 7445 (1995), *reconsideration pending* (*NYNEX USPP Order*); *Ameritech Operating Companies Petition for a Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region*, Order, FCC 96-58 (released Feb. 15, 1996) (*Ameritech Customers First Order*).

such as New York's "pay or play" system, which would impose intrastate access charges on non-access services rather than allowing incumbent LECs to recover non-cost-based revenues from purchasers of access services, may not be included in this interim system. Such a result is justified because state "pay or play" mechanisms do not at present constitute a significant revenue stream to incumbent LECs, and therefore elimination of this mechanism is unlikely, in the short term, to have significant detrimental effects on universal service support.

731. These state mechanisms must end on the earlier of: (1) June 30, 1997; or (2) if the incumbent LEC that receives the transitional access charge revenues is a BOC, the date on which that BOC is authorized under section 271 of the 1996 Act to offer in-region interLATA service. With one exception, the analysis provided above as to the rationale for the end dates for the transitional interstate access charge mechanism applies here as well. Because our access reform proceeding focuses on federal charges, and because the full extent of the section 254 universal service mechanism remains to be determined in that proceeding, intrastate access charge-based universal service support mechanisms should not now be required to terminate upon the completion of those proceedings.

732. As with our decision to permit incumbent LECs to continue to receive certain interstate access charge revenues from some purchasers of unbundled local switching for a limited period of time, we believe our decision to allow states to preserve certain intrastate universal service support mechanisms based on access charges is within our authority under section 251(d)(1) of the 1996 Act, and section 4(i) of the 1934 Act. Moreover, although section 251(g) does not directly refer to intrastate access charge mechanisms, it would be incongruous to conclude that Congress was concerned about the effects of potential disruption to the interstate access charge system, but had no such concerns about the effects on analogous intrastate mechanisms.

(c) Fifth Amendment Issues

733. We conclude that our decision that prices for incumbent LECs' unbundled elements and interconnection offerings be based on forward-looking economic cost does not violate the incumbent LECs' rights under the Fifth Amendment of the Constitution. The Supreme Court has recognized that public utilities owned and operated by private investors, even though their assets are employed in the public interest to provide consumers with service, may assert their rights under the Takings Clause of the Fifth Amendment.[1746] In applying the Takings Clause to rate setting for public utilities, the Court has stated that "[t]he guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public

[1746] The Fifth Amendment provides that, "private property [shall not] be taken for public use, without just compensation." U.S. Const. amend. V. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989) (*Duquesne*).

which is so 'unjust' as to be confiscatory."[1747]

734. The Supreme Court has held that the determination of whether a rate is confiscatory depends on whether that rate is just and reasonable, and not on what methodology is used.[1748] In *Federal Power Comm'n v. Hope Natural Gas Co.*, the Court upheld the Federal Power Commission's order that required the company to make a large reduction in wholesale gas rates. The commission based its determination of a reasonable rate of return on a plant valuation determined by using a historical cost methodology that was only half as large as the company's own valuation based on forward-looking reproduction costs. In its decision, the Court set forth the governing legal standard for determining whether a rate is constitutional:

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed that is controlling. It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[1749]

735. The Court went on to explain that, in determining whether a rate is reasonable, the regulatory body must balance the interests of both the investor and consumer.[1750] "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business . . . . [T]he return on the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[1751]

736. Under sections 251(c)(2) and (3) of the 1996 Act, incumbent LECs must establish

[1747] *Duquesne*, 488 U.S. at 307 (*citing Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896)).

[1748] *Hope Natural Gas*, 320 U.S. at 602-603; *see also Duquesne; In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); *Jersey Central Power & Light v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987).

[1749] *Hope Natural Gas*, 320 U.S. at 602.

[1750] *Id.*

[1751] *Id.* at 603.

rates for interconnection and unbundled elements that are just and reasonable.[1752] In adopting the rules that govern those rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed.[1753] Indeed, the Court has found that the "fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid."[1754] Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred.[1755] Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.

737. Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, including the revenues for other services under our jurisdiction.[1756]

738. In this proceeding, we are establishing pricing rules that should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost methodology enables incumbent LECs to recover a fair return on their investment, *i.e.*, just and reasonable rates. The record does not compel a contrary conclusion. No incumbent LEC has provided persuasive evidence that prices based on a forward-looking economic cost methodology would have a significant impact on its "financial integrity." We further note that at least one federal appellate court has held incremental cost-based pricing

[1752] 47 U.S.C. § 251(c)(2) and (3).

[1753] *See, e.g., Duquesne*, 488 U.S. at 310; *Hope Natural Gas*, 320 U.S. at 602.

[1754] *Hope Natural Gas*, 320 U.S. at 601.

[1755] *Duquesne*, 488 U.S. at 301-302.

[1756] However, we may not consider incumbent LECs' revenue derived from services not under our jurisdiction. *Smith v. Ill. Bell*, 282 U.S. 133 (1930).

constitutional.[1757]

739. Incumbent LECs may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates. We also do not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements. As stated above, we intend to explore this issue in detail in our upcoming access reform proceeding.

740. GTE argues that the proper standard to review our ratemaking methodology is the just compensation standard generally reserved for takings of property. This is in effect a contention that the 1996 Act's physical collocation and unbundled network facility requirements constitute physical occupation of their property that should be deemed a taking and that must be subject to "just compensation." Assuming for the sake of argument that the physical collocation and unbundled facilities requirements do result in a taking, we nevertheless find that the ratemaking methodology we have adopted satisfies the just compensation standard. Just compensation is normally measured by the fair market value of the property subject to the taking.[1758] Just compensation is not, however, intended to permit recovery of monopoly rents.[1759] The just and reasonable rate standard of TELRIC plus a reasonable allocation of the joint and common costs of providing network elements that we are adopting attempts to replicate, with respect to bottleneck monopoly elements, the rates that would be charged in a competitive market,[1760] and, we believe, is entirely consistent with the just compensation standard. Indeed, a similar rate methodology based on incremental costs has been found to satisfy the just compensation requirement.[1761] For these reasons, we conclude that, even if the 1996 Act's physical collocation and unbundled network facility requirements constitute a taking, a forward-looking economic cost methodology satisfies the Constitution's just compensation standard.

[1757] *Metropolitan Transp. Auth. v. Interstate Commerce Commission*, 792 F.2d 287, 297 (2d Cir.), *cert. denied*, 479 U.S. 1017 (1986).

[1758] *See, e.g., United States v. Miller*, 317 U.S. 369, 374 (1943) (holding that just compensation can readily be set by ascertaining the property's fair market value, *i.e.*, "what a willing buyer would pay in cash to a willing seller").

[1759] *See, e.g., Lord Mfg. Co. v. United States*, 84 F.Supp. 748, 755-56 (Ct.Cl. 1949), *citing United States v. Cors*, 337 U.S. 325, 334 (1949).

[1760] *Compare Policy and Rules Concerning Rates for Dominant Carriers*, Further Notice of Proposed Rulemaking, CC Docket No. 87-313, 3 FCC Rcd 3195, 3200-01 (1988).

[1761] *Metropolitan Transp. Auth. v. Interstate Commerce Commission*, 792 F.2d at 297.

3. Rate Structure Rules

a. General Rate Structure Rules

(1) Background

741. In addition to applying our economic pricing methodology to determine the rate level of a specific element or interconnection, the state must also determine the appropriate rate structure. We discuss in this section general principles for analyzing rate structure questions, such as in what circumstances charges should be flat-rated or usage sensitive and in what circumstances they should be recurring or non-recurring. These rate structure rules will apply as well if a state sets rates based on default proxies discussed in Section VII.C.2 below, where we also discuss the appropriate rate structure for specific network elements. Network providers incur costs in providing two broad categories of facilities, dedicated and shared. Dedicated facilities are those that are used by a single party -- either an end user or an interconnecting network. Shared facilities are those used by multiple parties. In the NPRM, we proposed that costs should be recovered in a manner that reflects the way they are incurred.[1762] We also sought comment on whether we should require states to provide for recovery of dedicated facility costs on a flat-rated basis, or at a minimum, require LECs to offer a flat-rate option.[1763]

(2) Comments

742. Parties from all sectors of the telecommunications industry agree that costs should be recovered in a manner that reflects the way they are incurred.[1764] Lincoln states that using an approach that varies with capacity, without taking into account the utilization of shared facilities, would not allow small and mid-sized LECs to recover their total costs, because they lack economies of scale and scope.[1765] No commenters take issue with that principle or the principle that the costs of dedicated facilities should be recovered through flat rates. A wide variety of

[1762] NPRM at para. 150.

[1763] *Id.* at para. 152.

[1764] *See, e.g.*, AT&T comments at 67; GSA/DoD comments at 10; Kentucky Commission comments at 5; Lincoln Tel. comments at 17; Sprint comments at 62; Texas Public Utility Counsel comments at 36; USTA comments at 57; LDDS comments at 57; NEXTLINK comments at 30 (generally supporting rate structures that reflect off-peak costs); Washington Commission comments at 24.

[1765] Lincoln Tel. comments at 17.

parties proposed that the Commission adopt such a rule.[1766] BellSouth, however, opposes rigid rate structure rules, and contends they could be detrimental if they preclude alternative structures to which parties are willing to agree.[1767]

(3) Discussion

743. We conclude, as a general rule, that incumbent LECs' rates for interconnection and unbundled elements must recover costs in a manner that reflects the way they are incurred. This will conform to the 1996 Act's requirement that rates be cost-based, ensure requesting carriers have the right incentives to construct and use public network facilities efficiently, and prevent incumbent LECs from inefficiently raising costs in order to deter entry. We note that this conclusion should facilitate competition on a reasonable and efficient basis by all firms in the industry by establishing prices for interconnection and unbundled elements based on costs similar to those incurred by the incumbents, which may be expected to reduce the regulatory burdens and economic impact of our decision for many parties, including both small entities seeking to enter the local exchange markets and small incumbent LECs.[1768] We also adopt some more specific rules that follow from this general rule.

744. First, we require that the charges for dedicated facilities be flat-rated, including, but not limited to, charges for unbundled loops, dedicated transport, interconnection, and collocation. These charges should be assessed for fixed periods, such as a month. We are requiring flat-rated charges for dedicated facilities. Usage-based charges for dedicated facilities would give purchasers of access to network elements an uneconomic incentive to reduce their traffic volumes. Moreover, purchasers of access to network elements with low volumes of traffic would pay below-cost prices, and therefore have an incentive to add lines that they would not add if they had to pay the full cost. As stated in the NPRM, a flat-rated charge is most efficient for dedicated facilities, because it ensures that a customer will pay the full cost of the facility, and no more. It ensures that an entrant will, for example, purchase the exclusive right to use additional loops only if the entrant believes that the benefits of the additional loops will exceed its costs. It also ensures that the entrant will not face an additional (and non-cost-based) usage charge.

745. Second, if we apply our general rule that costs should be recovered in a manner that reflects the way they are incurred, then recurring costs must be recovered through recurring charges, rather than through a nonrecurring charge. A recurring cost is one incurred periodically

[1766] *See, e.g.*, Florida Commission comments at 31; GSA/DoD comments at 10; MFS comments at 61-63; Ohio Consumers' Counsel comments at 30; Telecommunications Resellers Ass'n comments at 42.

[1767] BellSouth comments at 57-58.

[1768] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

over time. A LEC may not recover recurring costs such as income taxes, maintenance expenses, and administrative expenses through a nonrecurring charge because these are costs that are incurred in connection with the asset over time. For example, we determine that maintenance expenses relating to the local loop must be recovered through the recurring loop charge, rather than through a nonrecurring charge imposed upon the entrant.

746. We find that recovering a recurring cost through a nonrecurring charge would be unjust and unreasonable because it is unlikely that incumbent LECs will be able to calculate properly the present value of recurring costs. To calculate properly the present value of recurring costs, an incumbent LEC would have to project accurately the duration, level, and frequency of the recurring costs and estimate properly its overall cost of capital. We find that, in practice, the present value of the recurring costs cannot be calculated with sufficient accuracy to warrant up-front recovery of these costs because incumbent LECs lack sufficient experience with the provision of interconnection and unbundled rate elements. Without sufficient experience, incumbent LECs are unable to project the length of time that an average entrant would interconnect with, or take an unbundled element from, the incumbent LEC, or how expenses associated with interconnection and unbundled rate elements would change over time. In contrast, a recurring charge for a recurring cost would ensure that a customer is only charged for the costs the entrant incurs while that entrant is taking interconnection service or unbundled rate elements from the incumbent LEC. Moreover, when costs associated with the interconnection and particular unbundled rate elements change, the incumbent LEC can make appropriate adjustments to the charges at the time such cost changes occur.

747. Accordingly, we find that imposing nonrecurring charges for recurring costs could pose a barrier to entry because these charges may be excessive, reflecting costs that may (1) not actually occur; (2) be incurred later than predicted; (3) not be incurred for as long as predicted; (4) be incurred at a level that is lower than predicted; (5) be incurred less frequently than predicted; and (6) be discounted to the present using a cost of capital that is too low.

748. Notwithstanding the foregoing, where recurring costs are *de minimis*, we will permit incumbent LECs to recover such costs through nonrecurring charges. We find that recurring costs are *de minimis* where the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

749. Third, states may, but need not, require incumbent LECs in an arbitrated agreement to recover nonrecurring costs, costs that are incurred only once, through recurring charges over a reasonable period of time. The recovery of such nonrecurring costs through recurring charges is a common practice for telecommunications services. Construction of an interconnector's physical collocation cage is an example of a nonrecurring cost. We find that states may, where reasonable, require an incumbent LEC to recover construction costs for an interconnector's physical collocation cage as a recurring charge over a reasonable period of time in lieu of a nonrecurring charge. This arrangement would decrease the size of the entrant's initial capital

outlay, thereby reducing financial barriers to entry. At the same time, any such reasonable arrangement would ensure that incumbent LECs are fully compensated for their nonrecurring costs.

750. We require, however, that state commissions take steps to ensure that incumbent LECs do not recover nonrecurring costs twice and that nonrecurring charges are imposed equitably among entrants. A state commission may, for example, decide to permit incumbent LECs to charge the initial entrants the full amount of costs incurred for shared facilities for physical collocation service, even if future entrants may benefit. A state commission may, however, require subsequent entrants, who take physical collocation service in the same central office and receive benefits as a result of costs for shared facilities, to pay the incumbent LEC for their proportionate share of those costs, less depreciation (if an asset is involved). Under this approach, the state commission could require the incumbent LEC to provide the initial entrants *pro rata* refunds, reflecting the full amount of the charges collected from the subsequent entrants. Alternatively, a state commission may decide to permit incumbent LECs to charge initial entrants a proportionate fraction of the costs incurred, based on a reasonable estimate of the total demand by entrants for the particular interconnection service or unbundled rate elements.

751. In addition, state commissions must ensure that nonrecurring charges imposed by incumbent LECs are equitably allocated among entrants where such charges are imposed on one entrant for the use of an asset and another entrant uses the asset after the first entrant abandons the asset. For example, when an entrant pays a nonrecurring charge for construction of a physical collocation cage and the entrant discontinues occupying the cage before the end of the economic life of the cage, a state commission could require that the initial entrant receive a *pro rata* refund from the incumbent LEC for the undepreciated value of the cage in the event that a subsequent entrant takes physical collocation service and uses the asset. Under this approach, the state commission could require that the subsequent entrant pay the incumbent LEC a nonrecurring charge equal to the remaining unamortized value of the cage and the initial entrant will receive a credit from the incumbent LEC equal to the unamortized value of the cage at the time the subsequent entrant takes service and utilizes the cage.

752. BellSouth's concern that rate structure rules could preclude mutually agreeable alternative structures is misplaced. The rate structure rules we adopt here apply only to rates imposed by the states in arbitration among the parties and to state review of BOC statements of generally available terms. Our rules do not restrict parties from agreeing to alternative rate structures. On the contrary, our intent, following the clear pro-negotiation spirit of the 1996 Act, is for parties to use the backdrop of state arbitrations conducted under our rules, to negotiate more efficient, mutually agreeable arrangements, subject, of course, to the antitrust laws[1769] and to the 1996 Act's requirements that voluntarily negotiated agreements not unreasonably discriminate

[1769] Sherman Antitrust Act, 15 U.S.C. §§ 1 *et seq.*

against third parties.[1770]

b. Additional Rate Structure Rules for Shared Facilities

(1) Background

753. In the NPRM, we stated our belief that the costs of shared facilities should be recovered in a manner that efficiently apportions costs among users that share the facility. The NPRM noted that, for shared facilities, it may be efficient to set prices using any of the following: a usage-sensitive charge; a usage-sensitive charge for peak-time usage and a lower charge for off-peak usage; or a flat charge for the peak capacity that an interconnector wishes to pay for and use as though that portion of the facility were dedicated to the interconnector.[1771]

(2) Comments

754. USTA argues that shared facilities are more reasonably priced on a usage-sensitive basis.[1772] The Florida Commission and Telecommunications Resellers Association both contend that a variety of charges may be appropriate for shared facilities.[1773] Telecommunications Resellers Association further argues that the Commission should "require, where practicable, that LECs offer a flat-rated option with respect to common facilities and bear the burden of justifying instances in which they allege that such an option is not workable."[1774] AT&T makes a similar proposal, arguing that rates should generally be non-usage sensitive except where a usage-based charge is clearly required.[1775] Lincoln Tel. argues that costs of shared facilities should be apportioned among users of the shared facility and that a capacity approach that does not account for utilization of shared facilities would prevent small and mid-sized LECs from recovering their costs as they lack economies of scale.[1776]

[1770] *E.g.*, 47 U.S.C. § 252(e)(2)(A)(i).

[1771] NPRM at para. 151.

[1772] USTA comments at 57; *see also* Lincoln Tel. comments at 17; Sprint comments at 62; NTIA reply at 33-34.

[1773] Florida Commission comments at 31; Telecommunications Resellers Ass'n comments at 42.

[1774] Telecommunications Resellers Ass'n comments at 42.

[1775] AT&T comments at 67.

[1776] *See* Lincoln Tel. comments at 17.

(3) Discussion

755. The costs of shared facilities including, but not limited to, much of local switching, tandem switching, transmission facilities between the end office and the tandem switch, and signaling, should be recovered in a manner that efficiently apportions costs among users. Because the cost of capacity is determined by the volume of traffic that the facilities are able to handle during peak load periods, we believe, as a matter of economic theory, that if usage-sensitive rates are used, then somewhat higher rates should apply to peak period traffic, with lower rates for non-peak usage. The peak load price would be designed to recover at least the cost of the incremental network capacity added to carry peak period traffic. Pricing traffic during peak periods based on the cost of the incremental capacity needed to handle additional traffic would be economically efficient because additional traffic would be placed on the network if and only if the user or interconnecting network is willing to pay the cost of the incremental network capacity required to handle this additional traffic. Such pricing would ensure that a call made during the peak period generates enough revenue to cover the cost of the facilities expansion it requires, and would thus give carriers an incentive to expand and develop the network efficiently. In contrast, off-peak traffic imposes relatively little additional cost because it does not require any incremental capacity to be added to base plant, and consequently, the price for carrying off-peak traffic should be lower.

756. We recognize, however, that there are practical problems associated with a peak-sensitive pricing system. For example, different parts of a given provider's network may experience peak traffic volumes at different times (*e.g.*, business districts may experience their peak period between 10:00 and 11:00 a.m., while suburban areas may have their peak periods between 7:00 and 8:00 p.m.) Moreover, peak periods may change over time. For instance, growth in Internet usage may create new peak periods in the late evening. Further, charging different prices for calls made during different parts of the day may cause some customers to shift their calling to the less expensive time periods, which could shift the peak or create new peaks. Thus, to design an efficient peak-sensitive pricing system requires detailed knowledge of both the structure of costs as well as demand.

757. We conclude that the practical problems associated with peak-sensitive pricing make it inappropriate for us to require states to impose such a rate structure for unbundled local switching or other shared facilities whose costs vary with capacity. Because we believe that such a structure may be the most economically efficient, however, we do not prohibit states from imposing peak-sensitive pricing. We also expect that parties may be able to negotiate agreements with peak/off-peak differences if the benefits of such distinctions are sufficiently high. We conclude that states may use either usage-sensitive rates or flat capacity-based rates for shared facilities, if a state finds that such rates reasonably reflect the costs imposed by the various users. States may consider for guidance rate structures developed in competitive markets for shared facilities. We note that our decisions in this section may benefit small entity entrants in local exchange and exchange access markets by minimizing the extent to which purchasers of

interconnection and unbundled access pay rates that diverge from the costs of those facilities and services.[1777]

c. Geographic/Class-of-Service Averaging

(1) Background

758. In the NPRM, we asked about the appropriate level of aggregation for rates for interconnection and access to unbundled elements. We noted that geographic averaging is simple to administer and prevents unreasonable or unlawful rate differences but, where averaging covers high and low cost areas, it could distort competitors' decisions whether to lease unbundled elements or build their own facilities. We sought comment on the geographic deaveraging of interconnection and unbundled element rates by zone, LATA, or other area.[1778]

759. We also inquired about disaggregation by class of service. We questioned whether business and residential loops, or loops deployed using different technologies should be charged different rates, and how large a differential should be allowed.[1779]

(2) Comments

760. *Geographic Deaveraging.* Commenters generally agreed that rates for interconnection and unbundled elements should be geographically deaveraged where there are significant cost variations.[1780] Many parties assert that there are large geographic variations in the costs of providing these services and elements.[1781] Many commenters argue that rates for interconnection and unbundled elements must be geographically deaveraged in order to meet the

[1777] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[1778] NPRM at para. 133.

[1779] *Id.*

[1780] *See, e.g.*, Connecticut Commission comments at 13-14; N. Economides comments at 3; Maine Commission, *et al.* comments at 19. *Cf.* Colorado Commission comments at 41; Ohio Consumers' Counsel comments at 27-28 (deaveraging should be left to states); Pennsylvania Commission comments at 31 (noting industry movement towards deaveraging); Texas Commission at 24 (Commission should defer geographic deaveraging and rate rebalancing to universal service proceeding).

[1781] *See, e.g.*, Cincinnati Bell comments at 27; Lincoln Tel. comments at 14; Maine Commission, *et al.* comments at 27-28; Sprint comments at 50-51.

cost-based requirements of sections 251 and 252.[1782] Teleport maintains, however, that most geographic or class-of-service classifications have arisen from marketing or regulatory considerations and have no basis in cost causation.[1783] The Ad Hoc Telecommunications Users Committee fears the "balkanization of [incumbent] LECs' markets" and would only allow geographic deaveraging where incumbent LECs could demonstrate significant regional variation in their non-common costs.[1784] It claims that excessive pricing flexibility would encourage the recovery of common costs to be shifted from competitive markets to less competitive markets.[1785] Finally, MFS would have us require geographic averaging to deter anticompetitive, strategic pricing by incumbent LECs.[1786]

761. *Extent of Deaveraging.* Cincinnati Bell, Lincoln Tel., and MECA would place no limits on the degree of deaveraging that would be permitted.[1787] MCI and Sprint advocate deaveraging based on the population density in specified geographic areas or zones.[1788] AT&T also advocates zone density deaveraging and would have us require at least six zones.[1789] MFS proposes that prices could be averaged over several possible areas, with state-wide averaging being the maximum geographic area. To address concerns that widespread averaging may force low cost areas to subsidize high cost areas, MFS suggests that exchanges be assigned to a small number of cost bands based on access line density, but that rates be set at the state-wide average cost of the exchanges assigned to each zone.[1790] GST generally favors a level of disaggregation that would mitigate incumbent LEC administrative expenses, but would require loop components

[1782] AT&T comments at 60.

[1783] Teleport comments at 48.

[1784] Ad Hoc Telecommunications Users Committee comments at 47.

[1785] *Id.*

[1786] MFS comments at 55-56.

[1787] *See, e.g.*, Cincinnati Bell comments at 27; Lincoln Tel. comments at 14; MECA comments at 46.

[1788] MCI comments at 68; Sprint comments at 50; *see also* MFS comments at 55-57.

[1789] AT&T comments at 67.

[1790] MFS comments at 55-56.

such as drops to be deaveraged and priced at LRIC.[1791]

762. *Opposition to National Rule.* Many state commissions seek flexibility to determine the degree of deaveraging and argue that this issue should be left to the states.[1792] Several favor deaveraging wherever the benefits exceed the administrative costs.[1793] The Connecticut Commission has already allowed SNET to create four cost categories based on density.[1794] The Michigan Commission would deaverage rates for interconnection and access to unbundled elements only where competitive entry warrants such flexibility, subject to a TSLRIC floor constraint.[1795] Michigan Commission further states that there may also be non-competitive situations that warrant rate deaveraging, such as when a service has wide cost variances, when averaging may reduce subscription levels, or when deaveraging could provide more accurate market signals due to cost variation.[1796]

763. *Class-of-Service Deaveraging.* In contrast to the general support by parties for geographic deaveraging, only one party supports class-of-service deaveraging.[1797] That party, the Ohio Consumers' Counsel, argues that permitting intercategory restrictions on unbundled elements would be consistent with intercategory restrictions on resale, such as prohibitions against reselling residential services to business customers, which are permitted under the 1996 Act.[1798] Many parties argue that incumbent LECs should not be able to charge different rates for interconnection or unbundled elements based on the class of service being provided with the elements or the class

---

[1791] GST comments at 30.

[1792] *See, e.g.*, Colorado Commission comments at 41; Connecticut Commission comments at 13-14; Maine Commission, *et al.* comments at 19-21; Michigan Commission comments at 15; Texas Commission comments at 24; *see also* Ohio Consumers' Counsel comments at 27-28; California Commission reply at 18.

[1793] *See, e.g.*, Connecticut Commission comments at 13-14; Indiana Commission comments at 24; Mass. Commission comments at 11 n.5.

[1794] Connecticut Commission comments at 13-14.

[1795] Michigan Commission comments at 15-16.

[1796] *Id.*

[1797] Ohio Consumers' Counsel comments at 27-28.

[1798] *Id.*

of customer purchasing or using the interconnection or unbundled elements.[1799] According to most commenters, the 1996 Act's requirement that rates for interconnection and unbundled elements be cost-based generally precludes class-of-service rate differences, unless the costs of provision vary significantly across classes.[1800] Sprint adds that there is no cost justification for rates to differ when unbundled elements are used for business customers instead of residential customers. Sprint also argues that requiring different rates for newer, less-expensive elements would give entrants the incentive to avoid serving customers connected to older, more-expensive plant, which would leave incumbent LECs at systematic cost disadvantages.[1801]

(3) Discussion

764. *Geographic Deaveraging.* The 1996 Act mandates that rates for interconnection and unbundled elements be "based on the cost . . . of providing the interconnection of network elements." [1802] We agree with most parties that deaveraged rates more closely reflect the actual costs of providing interconnection and unbundled elements. Thus, we conclude that rates for interconnection and unbundled elements must be geographically deaveraged.

765. The record reflects that at least two states have implemented geographically-deaveraged rate zones.[1803] These rate zone pricing systems have generally included a minimum of three zones. In the *Expanded Interconnection* proceeding, the Commission also permitted LECs to implement a three zone structure.[1804] We conclude that three zones are presumptively sufficient to reflect geographic cost differences in setting rates for interconnection and unbundled elements, and that states may, but need not, use these existing density-related rate zones. Where such

---

[1799] *See, e.g.*, Koch comments at 3; GST comments at 30; Mass. Commission comments at 11; MFS comments at 56-57; Sprint comments at 50; Teleport comments at 48.

[1800] *See, e.g.*, Citizens comments at 18; Mass. Commission comments at 11; MFS comments at 56-57.

[1801] Sprint comments at 51.

[1802] 47 U.S.C. § 252(d)(1)(a)(i).

[1803] Connecticut Commission comments at 13; Illinois Commission comments at Attachment C (Illinois Commerce Commission Order), p.54, 60-61.

[1804] *Expanded Interconnection with Local Telephone Company Facilities and Amendment of the Part 69 Allocation of General Support Facility Costs*, CC Docket Nos. 91-141 and 92-222, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7454-57 (1992) (*Expanded Interconnection Order*); Second Report and Order and Third Notice of Proposed Rulemaking, 8 FCC Rcd 7374, 7426-29 (1993). LEC central offices in areas with the highest traffic densities were assigned to Zone 1; offices in areas with intermediate degrees of density were assigned to Zone 2; and offices in areas with the lowest density were assigned to Zone 3.

systems are not in existence, states shall create a minimum of three cost-related rate zones to implement deaveraged rates for interconnection and unbundled elements. A state may establish more than three zones where cost differences in geographic regions are such that it finds that additional zones are needed to adequately reflect the costs of interconnection and access to unbundled elements.

766. *Class-of-Service Deaveraging.* The record leads us to the opposite conclusion for class-of-service deaveraging. Under the 1996 Act, wholesale rates for resold services will be based on retail rates less avoided costs. Rates for interconnection and access to unbundled elements, however, are to be based on costs. We conclude that the pricing standard for interconnection and unbundled elements prohibits deaveraging that is not cost based. Interconnection and unbundled elements are intermediate services provided by incumbent LECs to other telecommunications carriers, and there is no evidence that the cost of providing these intermediate services varies with the class of service the telecommunications carrier is providing to its end-user customers. We conclude that states may not impose class-of-service deaveraging on rates for interconnection and unbundled elements. We disagree with the Ohio Consumers' Counsel's position that the 1996 Act's explicit permission of class-of-service deaveraging of resold services implies that class-of-service deaveraging should be permitted for interconnection and unbundled elements. Finally, we note that these decisions concerning averaging may be expected to lead to increased competition and a more efficient allocation of resources, which should benefit the entire industry, including small entities and small incumbent LECs.[1805]

C. Default Proxy Ceilings and Ranges

767. As previously discussed, we strongly encourage state commissions, as a general rule, to set arbitrated rates for interconnection and access to unbundled network elements pursuant to the forward-looking, economic cost pricing methodology we adopt in this Order. Such rates would approximate levels charged in a competitive market, would be economically efficient, and would be based on the forward-looking, economic cost of providing interconnection and unbundled elements. We recognize, however, that, in some cases, it may not be possible for carriers to prepare, or the state commission to review, economic cost studies within the statutory time frame for arbitration and thus here first address situations in which a state has not approved a cost study. States that do not complete their review of a forward-looking economic cost study within the statutory time periods but must render pricing decisions, will be able to establish interim arbitrated rates based on the proxies we provide in this Order. A proxy approach might provide a faster, administratively simpler, and less costly approach to establishing prices on an interim basis than a detailed forward-looking cost study.

768. The default proxies we establish will, in most cases, serve as presumptive ceilings. States may set prices below those ceilings if the record before them supports a lower price.

[1805] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

States should provide a reasoned basis for selecting a particular default price. In one case, for local switching, the default proxy is a range within which a state may set prices.

769. States that set prices based upon the default proxies must also require the parties to update the prices in the interconnection agreement on a going-forward basis, either after the state conducts or approves an economic study according to the cost-based pricing methodology or pursuant to any revision of the default proxy. We believe generic economic cost models,[1806] in principle, best comport with the preferred economic cost approach described previously, and we intend to examine further such models by the first quarter of 1997 to determine whether any of those models, with any appropriate modifications, could serve as better default proxies. Any updated price would take effect beginning at the time of the completed and approved study or the application of the revised default proxy.

770. Second, if a state has approved or conducted an economic cost study, prior to this Order, that complies with the methodology we adopt in this Order, the state may continue to apply the resulting rate even when not consistent with our default proxies. There must, however, be a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate.

771. Finally, while we provide for the use by states of default proxies, we recognize that certain states that are unable to utilize an economic cost study may wish to obtain the benefits of setting rates pursuant to such a study for its residents. The Commission will therefore entertain requests by states to review an economic cost study, to assist the state in conducting or reviewing such a study, or to conduct such a study.

1. Use of Proxies Generally

a. Background

772. In the NPRM, we discussed the possibility of setting certain outside limits for interconnection and unbundled element rates, in particular, by the use of proxies. We invited parties to comment on whether the use of certain proxies to set outer boundaries on the prices for interconnection and unbundled elements would be consistent with the pricing principles of the 1996 Act. Specifically, in the NPRM, we asked parties to comment on the benefits of various types of proxies: (1) generic cost studies, such as the Benchmark Cost Model and the Hatfield models;[1807] (2) some measure of nationally-averaged cost data;[1808] (3) rates in existing

[1806] *See* Section VII.C.3. *infra.*

[1807] NPRM at para. 137; *see infra*, Section VII.C.3, discussing generic cost models.

interconnection and unbundling arrangements between incumbent LECs and other providers of local service, such as neighboring incumbent LECs, CMRS providers, or other entrants in the same service area;[1809] (4) a subset of the incumbent LECs' existing interstate access rates, charged for interconnection with IXCs and other access customers, or an intrastate equivalent;[1810] (5) use of the interstate prices established in the *ONA* proceeding for unbundled features and functions of the local switch as ceilings for the same unbundled elements under section 251;[1811] and (6) any other administratively simple methods for establishing a ceiling for interconnection and unbundled network element rates.[1812] As a counterpart to ceilings, we also sought comment on whether it would be necessary or appropriate for us to establish floors for interconnection and unbundled element prices.[1813]

b. Comments

773. *Proxies Generally.* A number of parties offer general support for the use of cost proxies to establish upper limits on the rates that incumbent LECs may charge for interconnection and unbundled elements.[1814] Ad Hoc Telecommunications Users Committee cautions, however, that using a proxy approach does not eliminate the need for detailed analysis of the cost methodologies and cost inputs upon which the proxy is based.[1815] In addition, USTA contends that the Commission should establish a presumptive framework using targets based on pricing proxies, from which the states would be permitted to depart based on individual circumstances.[1816]

[1808] NPRM at para. 137.

[1809] *Id.* at para. 138.

[1810] *Id.* at paras. 139-140.

[1811] *Id.* at para. 140.

[1812] *Id.* at para. 141.

[1813] *Id.* at para. 143.

[1814] *See, e.g.*, GSA/DoD comments at 8; Cox comments at 31, reply at 30; WinStar comments at 31; NEXTLINK comments at 27-28; Texas Public Utility Counsel Comments at 28-33; NCTA comments at Attachment A (Declaration of Bruce M. Owen), pp.5-6, reply at 18-19; *see also* USTA comments at 50 ("may be a feasible way to establish presumptively valid rates for some unbundled elements").

[1815] Ad Hoc Telecommunications Users Committee comments at 48-49.

[1816] USTA reply at 19, 28; *see also* Washington Commission comments at 27.

774. Incumbent LECs and AT&T generally oppose the use of proxies.[1817] They argue that a national proxy methodology for all network elements is inappropriate because it would not reflect cost-based rates,[1818] may restrict competitive entry,[1819] does not allow for variations among the states,[1820] and is inconsistent with the 1996 Act's mandate of economic costing.[1821] Several commenters contend that the use of proxies could harm small and mid-sized incumbent LECs if such proxies are developed from larger geographic and demographic scales.[1822] In addition, Ameritech opposes the use of proxies for those states that have already adopted cost methodologies and urges the Commission to limit application of such proxies to states that have not yet adopted appropriate cost and pricing methodologies.[1823]

775. *Floors and Ceilings.* Several commenters oppose adoption of a federal floor and ceiling for the rates of interconnection and access to unbundled elements.[1824] They argue generally that such an approach is inferior to a prescription of a specific methodology because it results in rates that are not cost-based and therefore inconsistent with the statute, provides an incentive to incumbent LECs to price inefficiently at the maximum, and removes incentives for

[1817] *See, e.g.*, AT&T comments at 52-53; Bell Atlantic comments at 39; Cincinnati Bell comments at 27; Frontier comments at 22-23; LDDS comments at 65 n.66; Lincoln Tel. comments at 15-16.

[1818] *See, e.g.*, ALTS comments at 37; AT&T comments at 53; NYNEX comments at 53; Lincoln Tel. comments at 15-16; Texas Statewide Telephone Cooperative comments at 14; Rural Tel. Coalition comments at 22; Washington Independent Tel. Ass'n comments at 6.

[1819] *E.g.*, Cincinnati Bell comments at 28; AT&T comments at 53.

[1820] *See, e.g.*, Bell Atlantic comments at 39; Rural Tel. Coalition comments at 22; Wyoming Commission comments at 31; Alaska Commission comments at 2-3.

[1821] *See, e.g.*, ALTS comments at 35; Time Warner comments at 54-55; Washington Independent Tel. Ass'n comments at 6-7; Ohio Commission comments at 50.

[1822] *See, e.g.*, Cincinnati Bell comments at 28; Colorado Independent Tel. Ass'n comments at 4; Illinois Ind. Ass'n comments at 5; Lincoln Tel. comments at 17; Matanuska Tel. comments at 4; Rural Tel. Coalition comments at 22, 28-29; SBA comments at 16; TDS comments at 22.

[1823] Ameritech comments at 61.

[1824] *See, e.g.*, Frontier comments at 22; Lincoln Tel. comments at 14-15; MECA comments at 47; Pennsylvania Commission comments at 31; Telecommunications Resellers Ass'n comments at 41.

upgrading network technology.[1825] Moreover, any such price ceiling would have to be set as high as the reasonable price for the highest cost company or be challenged as confiscatory when higher cost LECs are unable to recover their costs.[1826] In addition, the Texas Public Utility Counsel notes that floors impair the ability of competition to reveal how low costs really are.[1827]

776. Many parties agree, however, that if the Commission establishes pricing guidelines it should use an "outer bounds" pricing approach or require pricing within a zone of reasonableness.[1828] Others support an "outer bounds" if the Commission ensures that states will have sufficient leeway to accommodate state-specific situations,[1829] and the range of reasonableness is not so circumscribed as to reduce the range to the equivalent of a price point.[1830] They argue that establishing separate floors and ceilings enables the Commission to set absolute boundaries that frame the debate with the incumbent LEC concerning relevant costs and prices during negotiations and ultimately arbitration, while giving states flexibility to address state-specific costing issues.[1831] Parties assert that calculation of a perfectly correct, single price is impossible and that cost boundaries allow states to choose an acceptable pricing result with a range of reasonable rates.[1832] Several parties agree that the Commission should establish a presumptive rate ceiling, and that rates exceeding the ceiling should be presumed unlawful.[1833] USTA contends that, if the Commission adopts rate ceilings, such ceilings should indicate levels

[1825] *See, e.g.*, NYNEX comments at 57; Frontier comments at 22-23; Lincoln Tel. comments at 14-15; AT&T comments at 52-53; TDS comments at 22.

[1826] Oregon Commission comments at 29-30; *see also* GVNW comments at 38-39.

[1827] Texas Public Utility Counsel comments at 33.

[1828] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 48; BellSouth comments at 55; Cox comments at 24; GSA/DoD comments at 8; NEXTLINK comments at 27-28; SBC comments at 93; USTA comments at 38; WinStar comments at 31; NCTA reply at 18.

[1829] *See, e.g.*, Kentucky Commission comments at 5; Ohio Consumers' Counsel comments at 29; Puerto Rico Tel. comments at 10-11; Washington Commission comments at 26.

[1830] *See, e.g.*, BellSouth comments at 55.

[1831] *See, e.g.*, GSA/DoD comments at 8; Cox comments at 24, reply at 30-31; NEXTLINK comments at 27-28.

[1832] *See, e.g.*, Rural Tel. Coalition comments at 30.

[1833] *See, e.g.*, ACSI comments at 56; Bell Atlantic comments at 39-40; Cincinnati Bell comments at 27, 30; MCI comments at 60; PacTel comments at 73-74; Texas Public Utility Counsel comments at 28-29.

above which rates must be further justified.[1834] Ameritech maintains that floors should be used only as a benchmark below which rates may not be set in order to guard against cross-subsidization and predatory pricing.[1835]

777. *Generic Cost Models.* Several generic forward-looking cost models were introduced into the record. These are discussed in Section VII.C.3. below.

778. *Nationally-Averaged Costs.* Although a few commenters support the use of nationally-averaged costs as a proxy to establish the rates for interconnection and unbundled network elements,[1836] many more parties oppose the use of such nationally-averaged cost data.[1837] These parties argue that nationally-averaged data ignore geographically divergent factors and the interests of small or rural LECs, do not account for variance of cost between incumbent LECs, and do not reflect the true cost of the service.[1838] No nationally-averaged cost studies were introduced into the record.

779. *Existing Interconnection Agreements.* Generally, commenters oppose the use of rates in existing interconnection agreements as a proxy-based ceiling for interconnection and unbundled element rates.[1839] These parties argue that, because the agreements are the subject of the negotiation between two carriers with their own particular characteristics and needs, such agreements are likely to be inconsistent and not cost-based, may not be based on the pricing standards codified at 252(d), and the services covered by these agreements may not be those that

[1834] USTA comments at 50.

[1835] Ameritech comments at 73; *see also* GSA/DoD comments at 8; Ohio Consumers' Counsel comments at 28; TDS comments at 20.

[1836] *See, e.g.*, MECA comments at 47; PacTel comments at 74; Sprint comments at 55; *see also* ACSI comments at 56.

[1837] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 49-50; Bay Springs, *et al.* comments at 17; Cincinnati Bell comments at 28; Colorado Independent. Tel. Ass'n comments at 4; Florida Commission comments at 29; Illinois Independent Tel. Ass'n comments at 5-6; Lincoln Tel. comments at 15-16; Telecommunications Resellers Ass'n comments at 41.

[1838] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 49; Bay Springs, *et al.* comments at 17; Cincinnati Bell comments at 28; GVNW comments at 31-38.

[1839] *See, e.g.*, ACSI comments at 58; Ad Hoc Telecommunications Users comments at 52; Cincinnati Bell comments at 28-29; Colorado Commission comments at 43; Florida Commission comments at 30; MCI comments at 70; Telecommunications Resellers Ass'n comments at 41.

entrants need to purchase.[1840] A few parties express qualified support for a proxy based on the rates in existing interconnection agreements between incumbent LECs, arguing that such rates have already been scrutinized and determined to be just and reasonable.[1841] WinStar cautions that the Commission should not use the rates contained in the existing interconnection agreements between incumbent LECs and CMRS providers or other new entrants as a proxy ceiling because they were negotiated by parties with unequal bargaining power.[1842]

780. *Interstate Access.* A number of parties support the use of a proxy based on existing interstate access charges, claiming that it is easy to apply, based on cost, and would be self-correcting as the access reform and universal service proceedings remove subsidies from access rates.[1843] ALLTEL further maintains that if access charges are used, there should be no requirement for small and mid-sized LECs to produce cost studies that could hamper their interconnection negotiations.[1844] USTA further argues that such proxies are important to all LECs, but are especially important for rural, small, and mid-sized LECs subject to the two percent waiver process, who should not be subjected to the burden of producing expensive and time-consuming cost studies.[1845] Several parties note that some access charges may need to be adjusted or converted to reflect the characteristics of particular unbundled service offerings.[1846] Others oppose the development of a proxy-based ceiling derived from existing interstate access rates, because access charges are based on historical, rather than economic, costs, and contain

[1840] *See, e.g.,* Ad Hoc Telecommunications Users Committee comments at 52; Florida Commission comments at 30; Telecommunications Resellers Ass'n comments at 41; Time Warner comments at 55.

[1841] *See, e.g.*, Bell Atlantic comments at 39-40; Ohio Consumers' Counsel comments at 28-29; PacTel reply at 34-35; Pennsylvania Commission comments at 31; Texas Commission comments at 24-25; WinStar comments at 32.

[1842] WinStar comments at 34; *see also* Telecommunications Resellers Ass'n comments at 41; ACSI comments at 58.

[1843] *See, e.g.*, ALLTEL comments at 10-11; Bell Atlantic comments at 39-40, 56; BellSouth comments at 56; Cincinnati Bell comments at 29; SBC comments at 94; USTA comments at 54, reply at 28.

[1844] ALLTEL comments at 11.

[1845] USTA reply at 27-28.

[1846] *See, e.g.*, Cincinnati Bell at 30; SBC comments at 95; USTA comments at 54.

inordinate amounts of contribution.[1847] These commenters note that setting rates for other elements that could not be derived from access rates would involve application of different proxies,[1848] and the intrastate and interstate rates associated with common lines are applied in different ways to different categories and classes of customers.[1849] NYNEX argues access charges were designed for a different purpose than interconnection and unbundled elements and therefore would be inappropriate proxies.[1850]

781. In addition, several parties assert that a proxy based on access charges should include all or part of the CCLC or TIC, because otherwise it would be impossible to determine whether an appropriate amount of joint and common costs would be recovered, and IXCs would be able to reconstruct access through unbundled elements priced less than access.[1851] GVNW argues that the TIC is particularly important for small LECs that are not allowed to charge a rate that more accurately reflects their tandem switched transport costs.[1852] On the other hand, several commenters argue that the CCLC and TIC should be excluded,[1853] and WinStar further maintains that, even without those elements, access charge rates would still be too high to serve as a proxy ceiling.[1854]

[1847] *See, e.g.*, ACSI comments at 58; Ad Hoc Telecommunications Users Committee comments at 52-53; Colorado Commission comments at 43; Frontier comments at 23; Lincoln Tel. comments at 15-16; MCI comments at 70; MFS comments at 57 n.66.

[1848] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 52-53.

[1849] *See, e.g.*, NYNEX comments at 59-60.

[1850] NYNEX comments at 58-59.

[1851] *See, e.g.*, Cincinnati Bell comments at 29; NYNEX comments at 59; Texas Commission comments at 25; USTA comments at 51-53.

[1852] GVNW comments at 39.

[1853] *See, e.g.*, Sprint comments at 58; Texas Public Utility Counsel comments at 30-32; WinStar comments at 36-37.

[1854] WinStar comments at 36-37.

c. Discussion

782. We adopt, in the section below, default proxies for particular network elements. We believe that these default proxies generally will result in reasonable price ceilings or price ranges and, for administrative and practical reasons, will be beneficial to the states in conducting initial rate arbitrations, especially in the time period prior to completion of a cost study. The proxies we adopt are designed to approximate prices that will enable competitors to enter the local exchange market swiftly and efficiently and will constrain the incumbent LECs' ability to preclude efficient entry by manipulating the allocation of common costs among services and elements. States that utilize the default proxies we establish to set prices in an arbitration should revise those prices on a going-forward basis when they are able to utilize the preferred economic costing methodology we describe in Section VII.B.2.a. above, or if we subsequently adopt new proxies.[1855]

783. We have considered the economic impact of the adoption of default proxy ceilings and ranges on small entities, including new entrants and small incumbent LECs.[1856] The adoption of proxies for interim arbitrated rates should minimize regulatory burdens on the parties to arbitration, including small entities seeking to enter the local exchange markets and small incumbent LECs, by permitting states to implement the 1996 Act more quickly and facilitating competition on a reasonable and efficient basis by all firms in the industry. We therefore believe that the adoption of default proxy ranges and ceilings advances the pro-competitive goals of the 1996 Act. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.[1857]

784. The proxies that we establish represent the price ceiling or price ranges for the particular element on an averaged basis. In Section VII.B.3.c. above, we required that rates be set on a geographically-deaveraged basis. Consequently, states utilizing the proxies shall set rates such that the average rate for the particular element in a study area does not exceed the applicable proxy ceiling or lie outside the proxy range.

785. We reject the use of rates in interconnection agreements that predate the 1996 Act as a proxy-based ceiling for interconnection and unbundled element rates.[1858] These existing interconnection agreements were not reached in a competitive market environment. Further, such agreements may reflect the divergent bargaining power of the parties to the agreement, various public policy initiatives to advance rural telephone service, or non-monetary *quid pro quos* often found in voluntarily negotiated business arrangements that may be difficult to quantify. There is little basis for us to conclude that rates in these interconnection agreements reflect the forward-looking, incremental cost of interconnection and unbundled network elements. Prices in agreements reached since the 1996 Act are more likely than prior agreements to provide useful information about forward-looking costs, which together with other information may be useful in establishing proxies.

786. In the NPRM, we also raised the issue of using some measure of nationally-averaged cost data as a proxy.[1859] No such study has been submitted into the record in this proceeding.

2. Proxies for Specific Elements

a. Overview

787. Although we encourage states to use an economic cost methodology to set rates for interconnection, unbundled network elements, and collocation, we will permit states unable to analyze an economic costing study within the statutory time constraints to use default proxies in setting and reviewing rates. We set forth below the default proxies for specific network elements. These proxies are interim only. They will apply only until a state sets rates in arbitrations on the basis of an economic cost study, or until we promulgate new proxies based on economic cost models.[1860] We also set forth below the rate structure rules that apply to each of network elements. These rate structure requirements are applicable regardless of whether a state uses an economic cost study or the proxy approach to set rate levels.

[1855] *See infra*, Section VII.C.3., discussing generic cost models.

[1856] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq*.

[1857] 47 U.S.C. § 251(f).

[1858] *See* discussion *supra*, Section III.C., concerning the applicability of section 252 to preexisting agreements.

[1859] NPRM at para. 137.

[1860] *See infra*, Section VII.C.3., discussing generic cost models.

b. Discussion

(1) Loops

(a) Comments

788. A number of commenters assert that unbundled loops, in particular, are dedicated facilities, and therefore should be priced on a flat-rated basis.[1861] Sprint suggests that prices for unbundled loops not depend on minutes of use, but rather distance.[1862] MFS urges the Commission to preempt a Texas statute that, it contends, requires incumbent LECs to price unbundled loops on a usage-sensitive basis.[1863]

(b) Discussion

789. Most loop costs are associated with a single customer.[1864] Outside plant between a customer's premises and ports on incumbent LEC switches is typically either physically separate for each individual customer, or has costs that can easily be apportioned among users. We therefore conclude that costs associated with unbundled loops should be recovered on a flat-rated basis. Usage-based rates for an unbundled loop would most likely translate into usage-based rates for new entrants' retail local customers. A retail usage-based rate would distort incentives for efficient use. Customers that had to pay a usage charge would have an incentive not to use the network in situations where the benefit of using the network exceeds the true cost of using the network. Usage-based loop prices would put an entrant at an artificial cost disadvantage when competing for high-volume customers.[1865]

790. In general, we believe that states should use a TELRIC methodology to establish

[1861] *See, e.g.*, CompTel comments at 36; Florida Commission comments at 31; MFS comments at 62; *see also* AT&T comments at 67; GSA/DoD comments at 10.

[1862] Sprint comments at 62.

[1863] MFS comments at 62.

[1864] *See MTS and WATS Market Structure*, CC Docket No. 78-72, Phase I, Third Report and Order, 93 FCC 2d 241, 291-297 (1983).

[1865] We note that MFS has filed a separate petition asking the Commission to preempt certain provisions of the Texas statute, which it contends requires incumbent LECs to sell unbundled local loops on a usage-sensitive basis. *See* Public Notice, *Petition for Preemption of Local Entry Barriers Pursuant to Section 253*, 11 FCC Rcd 6578 (Com. Car. Bur. 1996) (*MFS Texas Petition*). We will rule specifically on the Texas statute when we consider the *MFS Texas Petition*.

geographically deaveraged, flat-rate charges for access to unbundled loops. As discussed above, however, we recognize that, in some cases, it may not be possible for carriers to prepare, or for state commissions to review, economic cost studies within the statutory time frame for arbitration proceedings. Because reviewing and approving such cost studies takes time and because many states have not yet begun, or have only recently begun, to develop and examine such studies, it is critical for the near-term development of local competition to have proxies that provide an approximation of forward-looking economic costs and can be used by states almost immediately. These proxies would be used by a state commission until it is able either to complete a cost study or to evaluate and adopt the results of a study or studies submitted in the record. In an NPRM to be issued shortly, we will investigate more fully various long-run incremental cost models in the record with an eye to developing a model that can be used to generate proxies for the forward looking economic costs of network elements. Until such time as we can develop such a model, we have developed the following default proxy ceilings that state commissions that have not completed forward looking economic cost studies may use in the interim as an approximation to the forward looking cost of the local loop.

791. State commissions may use this proxy to derive a maximum (or ceiling) loop rate for each incumbent LEC operating within their state, and may establish actual unbundled loop rates at any level less than or equal to this maximum rate in specific arbitrations or other proceedings. Of course, we are encouraging states to have economic studies completed wherever feasible. Moreover, states will have to replace this proxy ceiling with the results of their own forward looking economic cost study or the results produced by a generic economic cost model that the Commission has approved.[1866]

792. We are adopting a proxy ceiling based on two cost models and rates for unbundled loops allowed by six states that had available to them the results of forward-looking economic cost studies at the time they considered either interim or permanent rates for the unbundled loop element. These states are Colorado, Connecticut, Florida, Illinois, Michigan, and Oregon. Each of these states has used a standard that appears to be reasonably close to the forward-looking economic cost methodology that we require to be used, although possibly not consistent in every detail with our TELRIC methodology.[1867] Generally, these states appear to have included an

[1866] *See infra*, Section VII.C.3., discussing generic cost models.

[1867] *See In re: US West Communications, Inc. Filing of Advice Letter No. 2610 In Compliance with Commission Decision No. C96-521 Adopting Emergency Rules (Tariff)*, Docket No. 96S-233T, Decision No. C96-655 (Colorado Commission, June 21, 1996)["*Colorado Decision*"] at 58-64 (interim unbundled loop prices set after review of TSLRIC cost studies); *Re Southern New England Telephone Company*, Order No. 95-06-17, 1995 WL 803837 (Conn. D.P.U.C., December 20, 1995)["*Connecticut Decision*"] at 9-10, 72 (same); *In re: application of City Signal, Inc., for an order establishing and approving interconnection arrangements with Ameritech Michigan*, Case No. U-10647 (Michigan Commission, February 23, 1995) ["*Michigan Decision*"] at 32, 56-57 (setting interim unbundled loop rates based on estimated TSLRIC costs); *In Re: Resolution of petition(s) to*

allocation of forward-looking common costs in their unbundled loop prices. The individual state studies resulted in the following average rates for unbundled local loops: Colorado, $18; Connecticut, $12.95; Florida, $17.28; Illinois, $10.93; Michigan, $10.03; and Oregon, $12.45, computed as set forth below.

793. The Colorado Commission set an interim rate of $18 per month for unbundled loops terminated at the main distribution frame of the LEC switch.[1868] The Connecticut Commission ruled that SNET must provide the following interim unbundled loop prices varying by four zones: metro $10.18; urban $11.33; suburban $15.33; and rural $14.97.[1869] In the absence of further information about customer density or average loop length by zone, we used a simple average equal to $12.95. The Florida Commission set an interim rate for 2-wire loops at $17.00 per month for BellSouth, $15.00 for United/Centel, and $20.00 for GTE.[1870] Using weights equal to the number of loops served by each company in 1994 as reported in the Monitoring Report,[1871] we computed a weighted average price equal to $17.28. Pursuant to its *Customers First* Order, the Illinois Commerce Commission approved tariffs establishing business rates equal to $7.08,

establish nondiscriminatory rates, terms and conditions for resale involving local exchange companies and alternative local exchange companies and alternative local exchanges companies pursuant to Section 364.161, Florida Statutes, Docket No. 950984-TP, Order No. PSC-96-0444-FOF-TP, (Florida Commission, March 29, 1996)["*Florida Decision I*"] at 16 (interim unbundled loop prices set with reference to BellSouth cost studies); *In Re: Resolution of petition(s) to establish nondiscriminatory rates, terms and conditions for resale involving local exchange companies and alternative local exchange companies and alternative local exchanges companies pursuant to Section 364.161, Florida Statutes*, Docket No. 950981-TP, Order No. PSC-96-0811-FOF-TP (Florida Commission, June 24, 1996)["*Florida Decision II*"] at 25-26 (setting rates after review of GTE and United/Centel cost studies); *In re: Investigation into the Cost of Providing Telecommunications Services*, Order No. 96-188, (Oregon Commission, July 19, 1996)["*Oregon Decision*"] at 78 n.61 (interim unbundled loop prices generally based on LRIC estimates plus applicable group related costs, and an additional contribution for recovery of joint and common costs); *Illinois Bell Telephone Company Proposed introduction of a trial of Ameritech's Customers First Plan in Illinois*, Docket Nos. 94-0096/94-0117/94-0146/94-0301 (Illinois Commission, April 7, 1995)["*Customers First* Order"] at 54, 61 (rates set with reference to Ameritech's LRSIC studies).

[1868] *Colorado Decision* at 66.

[1869] *Connecticut Decision* at 74.

[1870] *Florida Decision I* at 19; *Florida Decision II* at 25-26.

[1871] Monitoring Report, CC Docket No. 87-339, May 1996 (listing the following number of loops by company: GTE, 1,909,172; United/Centel, 1,627,314; BellSouth, 5,328,280).

$10.92, and $14.45, and residential rates equal to $4.59, $8.67, and $12.14 in three density zones.[1872] Based on data from Table 2.5, page 20 of the Common Carrier Statistics, 1995 Preliminary, we found a 36 percent - 64 percent business residential split. Using Illinois Commission data for number of households in each density zone (996,750 in zone A; 2,788,759 in zone B; 4,594,567 in zone C), we computed an average loop cost of $10.93. The Michigan Commission approved transitional rates of $8.00 per loop for business and $11 per loop for residence.[1873] Based on Common Carrier Statistics, 1995 Preliminary data, we computed a 32 percent - 68 percent business-residential split in Michigan, which leads to an average rate of $10.03. The Oregon Commission set the rate for a "basic 2-wire loop set" at $11.95 plus $0.50 for a network access channel connection, for a total price of $12.45.[1874]

794. In order to set a proxy ceiling for unbundled loop elements we make use of the two cost models for which nationwide data are available and upon which parties have had the opportunity to comment in this proceeding. These models are the Benchmark Cost Model (*BCM*)[1875] and the *Hatfield 2.2*.[1876] Based on our current information, we believe that both these models are based on detailed engineering and demographic assumptions that vary among states, and that the outputs of these models represent sufficiently reasonable predictions of relative cost differences among states to be used as set forth below to set a proxy ceiling on unbundled loop prices for each state. We do not believe, however, that these model outputs by themselves necessarily represent accurate estimates of the absolute magnitude of loop costs. As we discuss below, further analysis is necessary in order to evaluate fully the procedures and input assumptions that the models use in order to derive cost estimates. Furthermore, in the case of *BCM*, model outputs include costs in addition to the cost of the local loop. In order to correct for these considerations, we have developed a hybrid cost proxy in the following manner. First, we have applied a scaling factor to the cost estimates of each model. This scaling is based on the actual rates computed for unbundled loop elements in the six states referred to above. Specifically we have multiplied the cost estimate produced by each model in each state by a

[1872] *See* Ameritech Tariff, Ill. C.C. No. 20, Part 19, Section 1, issued October 23, 1995.

[1873] *Michigan Decision* at 94.

[1874] *Oregon Decision* at Appendix C, p.1.

[1875] *Benchmark Cost Model: A Joint Submission by MCI Communications, Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc.* (December 1995), submitted by MCI Communications, Inc., NYNEX Corp., Sprint/United Management Corp., U S West, Inc. on July 24, 1996 (*BCM*). For a more detailed discussion of the *BCM*, *see infra*, Section VII.C.3.

[1876] *Hatfield Model, Version 2.2, Release 1*, (Hatfield Associates, Inc., March 1996), submitted by AT&T and MCI on May 16, 1996 (*Hatfield 2.2*); *see also* AT&T reply at Appendix D (Update of the Hatfield Model Version 2.2, Release 1). *See infra*, Section VII.C.3., for a more detailed discussion of the various versions of the *Hatfield* model.

factor equal to the unweighted average of rates adopted by state commissions in the six states, divided by the unweighted average of the model cost estimates for the same six states. Our hybrid cost proxy is computed as the simple average of the scaled cost estimates for the two models in each of the 48 contiguous states and the District of Columbia. Neither *BCM* nor *Hatfield 2.2* provide cost estimates for Alaska and only the *BCM* provides an estimate for Hawaii. Our default loop cost proxies for Hawaii and Puerto Rico are based on the default loop cost proxies of the states that most closely approximate them in population density per square mile.[1877] We are not setting default loop cost proxies in this Order for Alaska or for any of the remaining non-contiguous areas subject to the 1996 Act requirement that incumbent LECs offer unbundled loop elements. We are not establishing default loop cost proxies for these areas because we are unsure that comparisons of the population densities of the continental states and of Alaska and other non-contiguous areas subject to the 1996 Act fully capture differences in loop costs. Regulatory authorities in those areas may seek assistance from this Commission should default loop cost proxies be needed before they have completed their investigations of the forward-looking costs of providing unbundled loop elements. Since our intention is to establish a ceiling for unbundled loop rates, we believe that it is necessary to take account of the variation in the data that we have used for scaling. While the six states that we considered appear to have based their rates on forward-looking economic cost pricing principles, the actual rates that they approved appear to reflect other factors as well. Furthermore, because only a small number of states have conducted such studies, some upward adjustment is warranted as a safety margin to ensure that the ceiling captures the variation in forward-looking economic costing prices on a state-by-state basis. We have therefore chosen to adjust the hybrid cost estimates upward by five percent for each state. A table listing the proxy ceilings on a statewide average basis is contained in Appendix D.

795. A number of parties have opposed the use of either the *Hatfield* model or *BCM*.[1878] Some critics, for example, have argued that the models may lead to inaccurate cost estimates since these estimates assume that a network is built "from scratch."[1879] Others have criticized specific procedures that have been used in the models to estimate both operating expenses and capital costs. As discussed below in Section VII.C.3., we believe that these criticisms may have merit. In a future rulemaking proceeding, we intend to examine in greater detail various forward looking economic cost models. For the purposes of setting an interim proxy, however, we note

[1877] There is a strong (negative) correlation between population density and the loop costs reported by all the cost models. The correlation is significant at the 5% level. Population densities are from The Statistical Abstract of the United States 1995, Table Number 23. For Puerto Rico, land area is from Table 361 and population is from Table 1345.

[1878] For a more detailed discussion of these generic cost models, *see infra*, Section VII.C.3.

[1879] *See, e.g.*, Florida Commission comments at 28-29; USTA comments at 54 n.45; Rural Tel. Coalition reply at 35.

that the criticisms have been directed largely toward the absolute level of cost estimates produced by the models, rather than the relative cost estimates across states. Since our hybrid proxy ceiling explicitly scales the model cost estimates based on existing state decisions and uses the model results simply to compute relative prices, we believe that these criticisms do not apply in the present context.

796. We also note that a third model, the *BCM 2*,[1880] could have been used in the construction of our interim cost proxy by simply taking the scaled cost estimates from three cost models instead of two. We have chosen not to follow this approach since parties have not had an opportunity to comment on the possible deficiencies of the *BCM 2*. For comparison purposes, however, we have computed the corresponding ceiling cost estimates, and have found that the scaled costs using the three model proxy are very similar to the estimated costs that were derived using the two models.[1881]

797. As discussed above, we believe that cost-based rates should be implemented on a geographically deaveraged basis. We allow states to determine the number of density zones within the state, provided that they designate at least three zones, but require that in all cases the weighted average of unbundled loop prices, with weights equal to the number of loops in each zone, should be less than the proxy ceiling set for the statewide average loop cost set forth in Appendix D.

798. As noted above, we have not yet had sufficient time to evaluate fully any of the cost models that have been submitted in the record, and our hybrid proxy is therefore intended to be used only on an interim basis. We believe that the methodology is consistent with forward-looking cost studies, but we also recognize that there may be situations in which forward looking loop costs will differ from computed costs, and accordingly, we have increased the state average loop costs by five percent and established the proxy as a ceiling. We emphasize that use of the hybrid proxy model can be superseded at any time by a full forward looking economic cost study that follows the guidelines set forth in this order. In addition, we are currently in the process of evaluating the more detailed cost models that have been submitted in the record,[1882] and will issue a further notice on the use of these models in the near future.

[1880] *Benchmark Cost Model 2* (July 1996), submitted by Sprint Corp. and U S West, Inc., on July 24, 1996 (*BCM 2*). For a more detailed discussion of this generic cost model, *see infra*, Section VII.C.3.

[1881] The coefficient of correlation is 0.991. Since the models are deterministic, this correlation does not reflect any relevant statistical properties of the models.

[1882] For a more detailed discussion of the cost models submitted in this docket, *see infra*, Section VII.C.3.

(2) Local Switching

(a) Comments

799. Several IXCs propose that local switching rates be part flat-rated and part usage-sensitive. LDDS argues that the price of the unbundled switching element should reflect as closely as possible the manner in which switching costs are incurred. It believes that line-related costs should be recovered through a flat per-line capacity charge, based on a contracted-for number of lines, with an additional usage-based trunking port charge and a combination of per-line and usage-based charges to recover busy hour related costs.[1883] AT&T similarly argues that switching rates should be based on a capacity charge for line-specific costs plus a usage sensitive charge based on calling volume.[1884] MCI states that switching costs are a function of line connections, trunk connections, and busy hour demand on the switch matrix and processor. Hence, the rate for the switching element should have a sub-element price relating to each sub-element, set to recover the associated TSLRIC.[1885] Sprint, on the other hand, contends that the charge for the local switching element should consist of two flat-rated charges, one based on the number of interconnector lines receiving dedicated access to the first point of concentration in the switch, and the second on the number of links between the termination equipment and the switch that an interconnector has ordered to provide it with switching capacity at its desired grade of service.[1886] CompTel argues that trunk port charges should be usage sensitive because trunk ports are used by multiple parties and that the network element for end-office serving wire center (provided by tandem switching) should be priced on a per minute basis.[1887]

800. Time Warner argues that pricing switched-based network elements on a flat-rated basis could give non-facilities-based competitors artificially created cost advantages over those who choose to invest in the development of competing networks.[1888] It also argues that nothing in the 1996 Act suggests that switches should not be priced based on a per-use basis rather than a

[1883] LDDS comments at 57.

[1884] AT&T comments at 68.

[1885] MCI comments at 30.

[1886] Sprint comments at 35, 62.

[1887] CompTel comments at 36, 45.

[1888] Time Warner comments at 59.

per-line or per-partitioned portion of the switch basis.[1889] NEXTLINK supports the use of rate structures that reflect peak and off-peak costs, but notes that the advantage of such structures must be balanced against the disadvantages of complexity and possible disputes that could arise with regard to more complex billing systems.[1890] The Washington Commission notes that the switched access price structure for interexchange access is usage sensitive, but it states that usage-sensitive pricing structures for switched access are inappropriate for local interconnection services in Washington because state law prohibits mandatory measured local service. To the extent that network element costs are driven by peak demand, the Washington Commission states that rates should reflect that tendency. It would prefer to see rate structures that more accurately reflect peak, rather than average demand and has expressed a strong interest in flat-rated port charges. The Washington Commission states that a flat rate based upon cost of providing capacity at peak load is possibly the most economically correct pricing mechanism; off-peak usage then is at virtually zero cost.[1891]

801. LDDS and AT&T argue that there should be no additional charges for vertical features provided by the switch, as the cost of providing those features should already be reflected in the charge for unbundled local switching.[1892] MCI has a similar view, arguing that, because incumbent LECs do not incur the cost of vertical features on a usage basis, custom calling features should be included in the price for unbundled local switching.[1893]

802. Incumbent LECs and Sprint, however, argue that vertical features are retail services offered to end users today, and must be purchased by the competitor under the wholesale rate provision of the 1996 Act.[1894] In making that argument, however, Sprint notes that although it is not technically feasible to unbundle vertical services the costs of such services can be identified and should be excluded from the price of the local switching element.[1895] Bell Atlantic notes that services currently sold at a loss are subsidized by vertical service offerings. It asserts that, if these offerings were treated as unbundled elements that must be provided at cost instead of

[1889] Time Warner comments at 59.

[1890] NEXTLINK comments at 30.

[1891] Washington Commission comments at 29-30.

[1892] AT&T comments at 21 n.22; LDDS comments at 56-57.

[1893] MCI comments at 31.

[1894] *See, e.g.*, SBC comments at 38; Sprint comments at 36-37.

[1895] Sprint comments at 37 n.15.

wholesale retail services, then a serious takings issue would arise.[1896] ALLTEL contends that the Commission should not permit the 1996 Act's resale price standards to be undercut by carriers attempting to mimic LEC networks by assembling unbundled elements obtained at below cost prices.[1897] USTA contends that section 251(c) does not allow carriers to assemble unbundled network elements to reconstruct and provide retail services offered by the incumbent LECs.[1898] The Competition Policy Institute argues in response, that the existence of unbundled network elements should not be presumed to be a substitute for a resold service.[1899] NYNEX argues that a competitor should not be allowed to obtain resold local exchange service and ask for vertical features at cost-based rates. It argues that the two competitive vehicles were intended to meet different strategic needs; they were not intended to provide opportunities for arbitrage.[1900]

803. Several commenters included estimates of the cost for end-office switching. MCI provides an estimate of the cost of end-office switching as calculated by the *Hatfield 2* model.[1901] Using the least cost, most efficient technology available in the market at the time, MCI estimates that the TSLRIC of end-office switching is equal to 0.18 cents ($0.0018) per minute of use.[1902] AT&T provides an updated version of the *Hatfield 2* model, the *Hatfield 2.2*, which treats the incumbent LECs' current wire center locations as "fixed" nodes in a reconstructed network.[1903] Cox reports that the *Hatfield 2.2* model estimates that average TSLRIC of end office switching

[1896] Bell Atlantic reply at Exhibit 2 (Declaration of Richard A. Epstein), p.7.

[1897] ALLTEL reply at 7.

[1898] USTA reply at 8.

[1899] Competition Policy Institute comments at 26.

[1900] NYNEX comments at 30, 36, 39.

[1901] MCI comments at Attachment 1, "The Cost of Basic Network Elements, Theory, Modeling, and Policy Implications," prepared for MCI by Hatfield Assoc., Inc.

[1902] *Id.* at 34; *see also* NCTA comments at Attachment 1 (Declaration of Bruce M. Owen), p. 34-35 (converting the *Hatfield 2* estimate for end-office switching and switch port costs into a per minute rate of 0.26 cents).

[1903] *Hatfield Model, Version 2.2, Release 1*, (Hatfield Associates, Inc., March 1996), submitted by AT&T and MCI on May 16, 1996 (*Hatfield 2.2*); *see also* AT&T reply at Appendix D (Update of the Hatfield Model Version 2.2, Release 1), p.1-3.

for most states clusters around 0.2 cents ($0.002) per minute of use.[1904]

804. GTE criticizes the *Hatfield 2.2* model and its assumptions, arguing that the Hatfield model suffers from serious inaccuracies and produces results that are inconsistent with what can actually be observed.[1905] GTE reports that the Cost Proxy Model, which was submitted by Pacific Telesis,[1906] estimates the average cost of routing traffic through end-office switches is equal to 0.35 cents ($0.0035) per minute of use.[1907]

805. In pleadings filed in the *LEC-CMRS Interconnection* proceeding,[1908] Cox asserts that the average incremental cost of inter-office transport and termination of traffic is 0.2 cents ($0.002) per minute of use.[1909] In the same proceeding, U S West argues that Cox's estimate of 0.2 cents per minute of use ignores the large differential between the costs of terminating calls during peak and off-peak hours.[1910] USTA claims that the average incremental cost of call

[1904] Letter from J.G. Harrington, Dow, Lohnes & Albertson, on behalf of Cox Communications, to William F. Caton, Acting Secretary, FCC, June 20, 1996, in CC Docket No. 95-185, at Tab 2 (Review of Record on LEC Local transport and Termination Costs Finding from LEC Cost Studies), p.3 (*Cox June 20, 1996 Ex Parte*).

[1905] Letter from Whitney Hatch, Assistant Vice President Regulatory Affairs, GTE, to William F. Caton, Acting Secretary, FCC, July 11, 1996 at Attachment 2 (Economic Evaluation of Version 2.2 of the Hatfield Model).

[1906] *The Cost Proxy Model* (INDETEC International, 1996), submitted by Pacific Telesis Group on June 7, 1996 (*CPM*).

[1907] Letter from Whitney Hatch, Assistant Vice President Regulatory Affairs, GTE, to William F. Caton, Acting Secretary, FCC, July 11, 1996 at Attachment 2 (Economic Evaluation of Version 2.2 of the Hatfield Model), pp.16-17.

[1908] *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, Notice of Proposed Rulemaking, 11 FCC Rcd 5020, 5038 (1996) (*LEC -CMRS Interconnection NPRM*);

[1909] Letter from J.G. Harrington, Dow, Lohnes & Albertson, on behalf of Cox Communications, to William F. Caton, Acting Secretary, FCC, June 20, 1996, in CC Docket No. 95-185 at Tab 2 (Review of Record on LEC Local Transport and Termination Costs Finding from LEC Cost Studies), pp.1-2; *see also* Letter from Robert F. Roche, CTIA, to William F. Caton, Acting Secretary, FCC, December 8, 1995, in CC Docket No. 94-54, (Incremental Cost of Local Usage, Brock Paper No. 3), p.1.

[1910] U S West comments in CC Docket No. 95-185 at Attachment A (A Response to Dr. Gerald Brock), p.13.

termination is 1.3 cents ($0.013) per minute of use.[1911]

806. In response to the *LEC-CMRS Interconnection NPRM*, many commenters assert that the majority of CMRS providers interconnect with incumbent LEC networks at incumbent LECs' tandem offices.[1912] U S West asserts that Cox's estimate of 0.2 cents ($0.002) per minute of use underestimates the actual cost of transporting and terminating traffic, and claims that, using the same data and methodology as Cox, the incremental cost of transporting and terminating traffic through the tandem is approximately three times higher than Cox's estimate.[1913] In the same proceeding, AirTouch, relying on 1994 testimony before the Georgia Commission, asserts that the LRIC of transporting and terminating a call through the tandem equals approximately 0.49 cents ($0.0049) for the first minute of a call and 0.12 cents ($0.0012) for each additional minute of use.[1914] This estimate is based on the presumption that it should cost roughly half as much to complete a call interchanged at a tandem switch as it does to both originate and terminate a call entirely on one network.[1915] Pacific Bell, asserts that the average LRIC for termination of calls under "Feature Group B," which appears to include terminations at tandems switches in addition to end-office terminations, equals 0.62 ($0.0062) cents per minute of use.[1916]

807. State commissions, that have set rates for the transport and termination of traffic, generally set rates for terminations where parties interconnect at either the end office or the tandem office.[1917] The Maryland Commission has set reciprocal and symmetrical rates for the transport and termination of traffic based, among other things, on a rate proposal calculated by a

[1911] USTA comments in CC Docket No. 95-185 at Attachment (Bill and Keep: A Bad Solution to a Non-Problem), pp.9-10.

[1912] *See, e.g.*, U S West comments in CC Docket No. 95-185 at Attachment A (A Response to Dr. Gerald Brock), p.13.

[1913] *Id.*

[1914] AirTouch comments in CC Docket No. 95-185 at 32-33.

[1915] *Id.*

[1916] Pacific Bell comments in CC Docket No. 95-185 at Exhibit B (Statement of Professor Jerry A. Hausman) at p.14.

[1917] *See, e.g.*, Maryland Commission comments at Appendix B (Maryland Commission Order No. 72348, Case No. 8584 Phase II), p.28-32.

staff witness.[1918] In the Maryland proceeding, the actual cost of tandem and end-office switch terminations are considered proprietary and were, therefore, not directly reported, but the staff witness testified that the calculation of direct, shared, and common costs is less than one-half his proposed rate of 0.6 cents ($0.006) per minute of use for terminations routed through the tandem-office switch.[1919] The Maryland Commission ultimately adopted rates of 0.3 cents ($0.003) per minute of use end-office-switch terminations and 0.5 cents ($0.005) per minute of use for terminations at the tandem switch.[1920]

808. The Illinois Commission has adopted a rate equal to 0.5 cents ($0.005) per minute of use for terminations routed directly through end-office switches and 0.75 cents ($0.0075) per minute of use for calls routed through tandem switches.[1921] Illinois's rate includes an element for recovering a "contribution" over and above the long-run service incremental cost of termination.[1922] Illinois arrived at its final rates by identifying the proposed rates that would pass imputation tests.[1923] In Massachusetts, NYNEX testified that the average marginal cost of end-office switching equals 0.129 ($0.00129) cents per minute of use.[1924] Cox reports that the Florida staff, after reviewing local service cost support data filed by GTE and Centel/United, concluded that the sum of the estimated TSLRIC for end-office switching and the LRIC for tandem-office switching and transport equals 0.25 cents ($0.0025) per minute of use.[1925]

809. The peak-period interconnection rates in New York between NYNEX and other facilities-based, full service local exchange providers are set at 0.74 cents ($0.0074) per minute of

[1918] *Id.*

[1919] *Id.* at 29.

[1920] *Id.* at 32.

[1921] Illinois Commission comments at Attachment C (Illinois Commerce Commission Docket No. 94.0096), pp.83-86, 98.

[1922] *Id.*

[1923] *Id.* at 85.

[1924] *See* Mass. Commission comments at Attachment 3 (Testimony of Paula L. Brown, Managing Director, NYNEX Corporation, in Massachusetts Dept. of Pub. Util. Docket No. 93-125, Workpaper 2), June 14, 1993, p.6.

[1925] *Cox June 20, 1996 Ex Parte* at 4 (*citing* Florida Docket No. 950985-TP).

use (end office) and 0.98 cents ($0.0098) per minute of use (tandem).[1926] Off-peak rates are 0.27 cents ($0.0027) (end office) and 0.29 cents ($0.0029) (tandem).[1927] The Michigan Commission has established mutual compensation rates of 1.5 cents ($0.015) per minute of use for calls passing directly through an end-office switch or through tandem office switches.[1928]

(b) Discussion

810. We conclude that a combination of a flat-rated charge for line ports, which are dedicated to a single new entrant, and either a flat-rate or per-minute usage charge for the switching matrix and for trunk ports, which constitute shared facilities, best reflects the way costs for unbundled local switching are incurred and is therefore reasonable. We find that there is an insufficient basis in the record to conclude that we should require two flat rates for unbundled local switching charges as proposed by Sprint.

811. Based on the record in this proceeding and in the *LEC-CMRS Interconnection* proceeding, we conclude that a range between 0.2 cents ($0.002) per minute of use and 0.4 cents ($0.004) per minute of use for unbundled local switching is a reasonable default proxy. In setting this default price range, we consider the range of evidence in the record, and believe that the most credible studies fall at the lower end of this range.[1929] However, so as to minimize disruption for any state that has set a rate only marginally outside this range, we will grandfather any state that has set a rate at 0.5 cents ($0.005) per minute of use or less pending completion of an economic study pursuant to the methodology set forth in this Order.

812. The forward-looking cost studies contained in the record estimate that the average cost of end-office switching ranges from 0.18 cents ($0.0018) per minute of use[1930] to 0.35 cents

---

[1926] *Competition, The State Experience* at 81 (compilation of written responses by state commission staffs to questions by FCC staff, compiled by NARUC) (March 8, 1996).

[1927] *Id.*

[1928] Michigan Commission comments at Attachment 1 (State of Michigan, Case No. U-10647, Opinion and Order, February 23, 1995), p.28.

[1929] *See, e.g.*, Maryland Commission comments at Appendix B (Maryland Commission Order No. 72348, Case No. 8548 Phase II), p.28-32; Letter from Robert F. Roche, CTIA, to William F. Caton, Acting Secretary, FCC, December 8, 1995, in CC Docket No. 94-54 (Incremental Cost of Local Usage, Brock Paper No. 3), p.1; *Hatfield Model, Version 2.2, Release 1*, (Hatfield Associates, Inc. March 1996), submitted by AT&T and MCI on May 16, 1996; AT&T reply at Appendix D (Update of the Hatfield Model, Version 2.2, Release 1).

[1930] *See* MCI comments at Attachment 1, "The Cost of Basic Network Elements, Theory, Modeling, and Policy Implications," prepared for MCI by Hatfield Assoc., Inc. p.34.

($0.0035) per minute of use.[1931] Maryland and Florida have adopted rates based on forward-looking economic cost studies that fall within the default price range we are adopting.[1932] NYNEX's estimate of 0.129 cents ($0.00129) per minute of use, in the Massachusetts proceeding, is estimate an estimate of the marginal cost of end-office switching.[1933] As discussed above, we generally expect studies estimating marginal costs to generate estimates that are less than estimates derived from TELRIC-based studies. We, therefore, conclude that 0.2 cents ($0.002) per minute of use is a reasonable lower end of the price range for end-office switching.

813. USTA's estimate of 1.3 cents ($0.013) appears to be an outlier that is significantly higher than the other estimates.[1934] We find that USTA's estimate does not represent an appropriate cost model for termination of traffic. USTA's estimate is based on the high end of a set of econometric estimates of LEC-reported cost data rather than an independent cost estimate, and USTA gives no explanation of why we should regard this as the best estimate. In addition, USTA's figure is derived, at least in part, from studies that attempt to measure the incremental cost of end-to-end use of the network for local calls, not the cost of local switching. Pacific Bell's study of the average LRIC of a call terminating under "Feature Group B"[1935] apparently includes terminations at tandem switches in addition to end-office terminations.

814. Michigan and Illinois have adopted rates for transport and termination of traffic that are higher than the default price range we adopt for end-office switching.[1936] Michigan, which established mutual compensation rates of 1.5 cents ($0.015) per minute of use, did not review a

---

[1931] Letter from Whitney Hatch, Assistant Vice President Regulatory Affairs, GTE, to William F. Caton, Acting Secretary, FCC, July 11, 1996 at Attachment 2 (Economic Evaluation of Version 2.2 of the Hatfield Model), pp.16-17.

[1932] *See* Maryland Commission comments at Appendix B (Maryland Commission Order No. 72348, Case No. 8584 Phase II), pp.28-32; *Cox June 20, 1996 Ex Parte* at 4.

[1933] *See* Mass. Commission comments at Attachment 3 (Testimony of Paula L. Brown, Managing Director, NYNEX Corporation, in Massachusetts Dept. of Pub. Util. Docket No. 93-125, Workpaper 2), p.6.

[1934] USTA comments in CC Docket No. 95-185 at Attachment (Bill and Keep: A Bad Solution to a Non-Problem), pp.9-10.

[1935] Pacific Bell comments in CC Docket No. 95-185 at Exhibit B (Submission of Jerry A. Hausman), para. 32.

[1936] Michigan Commission comments at Attachment 1 (State of Michigan, Case No. U-10647, Opinion and Order, February 23, 1995), p.28; Illinois Commission comments at Attachment C (Illinois Commerce Commission Docket No. 94.0096), pp.83-86, 98.

forward-looking cost study.[1937] Illinois's 0.5 cents ($0.005) per minute rate for termination through the end office is just outside the range we are establishing. First, as previously stated, we are grandfathering rates of 0.5 cents ($0.005) per minute or lower. Further, we do not believe Illinois's rate overrides the weight of evidence in the record, which supports the range we are establishing.

815. States that do not calculate the rate for the unbundled local switching element pursuant to a forward-looking economic cost study may, in the interim, set the rate so that the sum of the flat-rated charge for line ports and the product of the projected minutes of use per port and the usage-sensitive charges for switching and trunk ports, all divided by the projected minutes of use, does not exceed 0.4 cents ($0.004) per minute of use and is not lower than 0.2 cents ($0.002) per minute of use. A state may impose a rate for unbundled local switching that is outside this range if it finds that a forward-looking economic cost study shows a higher or lower rate is justified. States that use our proxy and impose flat-rated charges for unbundled local switching should set rates so that the price falls within the range of 0.2 cents ($0.002) per minute of use and 0.4 cents ($0.004) per minute of use if converted through use of a geographically disaggregated average usage factor. A default price range of 0.2 cents ($0.002) per minute of use and 0.4 cents ($0.004) per minute of use should allow carriers the opportunity to recover fully their additional cost of terminating a call including, according to Maryland's study, a reasonable allocation of common costs. We observe that the most credible studies in the record before us fall at the lower end of this range and we encourage states to consider such evidence in their analysis.

816. With respect to the argument that vertical features should be priced pursuant to the resale price standards, we concluded earlier that vertical features are part of the unbundled local switching element, because they are provided through the operation of hardware and software comprising the "facility" that is the switch.[1938] Accordingly, the pricing standard in 252(d)(1) applies to vertical features as part of the functionality of the switch. As previously discussed, allowing new entrants to purchase switching and vertical features as part of the local switching network element is an integral part of a separate option Congress has provided for new entrants to compete against incumbent LECs.[1939]

[1937] Michigan Commission comments at Attachment 1 (State of Michigan, Case No. U-10647, Opinion and Order, February 23, 1995), p.28.

[1938] *See supra*, Section V.J., discussing unbundled local switching.

[1939] "[I]t is unlikely that competitors will have a fully redundant network in place when they initially offer local service, because the investment necessary is so significant. Some facilities and capabilities . . . will likely need to be obtained from the incumbent [LEC] as network elements pursuant to new section 251." Joint Explanatory Statement at 148.

817. The 1996 Act establishes different pricing standards for these two options available to new entrants -- resale of services pursuant to section 251(c)(4) and unbundled elements pursuant to section 251(c)(3). Where the new entrant purchases vertical features as part of its purchase of an unbundled local switching element, the price of that element, including associated vertical features, should be determined according to section 252(d)(1). The availability of vertical services as part of a wholesale service offering is distinct from their availability as part of the local switching network element. In these circumstances, allowing the new entrant to combine unbundled elements with wholesale services is an option that is not necessary to permit the new entrant to enter the local market.

818. As to Bell Atlantic's takings argument, we concluded above that the pricing of unbundled elements according to the just and reasonable standard in section 251(c)(2) and (c)(3), and applied in section 252(d)(1), is not an unconstitutional taking.[1940] That analysis, which looks at the overall rates established by our regulations, applies with equal force to the pricing of unbundled local switching, inclusive of associated vertical features. A forward-looking economic cost methodology enables incumbent LECs to recover a fair return on their investments and Bell Atlantic has provided no specific evidence to the contrary. We conclude that our pricing methodology for unbundled local switching, inclusive of associated vertical features, provides just compensation to incumbent LECs.

(3) Other Elements

(a) Comments

819. AT&T argues that charges for common transport should be usage sensitive, and that signaling links, signal transfer point, and service control point should be priced using a combination of flat-rated capacity charges and usage-sensitive charges.[1941] The Ohio Consumers' Counsel agrees with AT&T about the principles of rate structure, but argues that the specific prescriptions for rate structure proposed by AT&T are unnecessary if the principles are adopted.[1942] Sprint asserts that common transport rates should be per-minute charges that vary with distance.[1943] MCI argues that trunk connection costs should be recovered through a minute-

---

[1940] *See supra*, Section VII.B.2.a.(3)(c).

[1941] AT&T comments at 68.

[1942] Ohio Consumers' Counsel reply at 16.

[1943] Sprint comments at 63.

of-use charge.[1944] AT&T argues that dedicated transport rates should be non-usage sensitive.[1945]

(b) Discussion

820. The primary categories of network elements identified in this Order, other than loops and switching, are transport, signaling, and collocation. Our rule that dedicated facilities shall be priced on a flat-rated basis[1946] applies to dedicated transmission links because these facilities are dedicated to the use of a specific customer.

821. For dedicated transmission links, states must use existing rates for interstate dedicated switched transport as a default proxy ceiling. We believe these rates are currently at or close to economic cost levels. Such rates were set based on interstate special access rates, which we found based on the record in the *Transport* proceeding were relatively close to costs.[1947] These interstate access rates originally were based on incumbent LEC accounting costs, rather than a forward-looking economic cost model. Since 1991, however, incumbent LEC interstate access rates have been subject to price cap regulation, and have therefore been disengaged from embedded costs.[1948]

822. Typically, transmission facilities between tandem switches and end offices are shared facilities. Pursuant to our rate structure guidelines, states may establish usage-sensitive or flat-rate charges to recover those costs. For shared transmission facilities between tandem switches and end offices, states may use as a default proxy ceiling the rate derived from the incumbent LEC's interstate direct trunked transport rates in the same manner that we derive presumptive price caps for tandem switched transport under our interstate price cap rules, using the same

[1944] MCI comments at 30.

[1945] AT&T comments at 67.

[1946] *See supra*, Section VII.B.3.

[1947] *First Transport Order*, 7 FCC Rcd at 7028 (1992); *Transport Rate Structure and Pricing*, CC Docket No. 91-213, Third Memorandum Opinion and Order on Reconsideration and Supplemental Notice of Proposed Rulemaking, 10 FCC Rcd 3030, 3038-39 (1994).

[1948] Interstate access rates for dedicated transport vary by region, type of circuit, mileage, and other factors. For example, BellSouth's entrance facility charge, for transport from an IXC's point of presence to a BellSouth serving wire center, is $134 monthly per DS1 circuit ($5.58 per derived voice grade circuit) and $2,100 monthly per DS3 circuit ($3.13 per derived voice grade circuit). Dedicated transport for 10 miles of interoffice transmission between a serving wire center and an end office is $325 monthly per DS1 circuit ($13.54 per derived voice grade circuit) and $2,950 monthly per DS3 circuit ($4.39 per derived voice grade circuit). Installation, multiplexing, and other transport-related charges may also apply.

weighting and loading factors.[1949] We conclude above that interstate direct-trunked transport rates provide a reasonable default proxy ceiling for unbundled dedicated transport rates. When we restructured the incumbent LECs' interstate transport rates to be more closely aligned with cost, we derived presumptive tandem-switched transmission rate levels from direct-trunked transport rates.[1950] This proxy ceiling for shared transmission facilities between tandem switches and end offices, therefore, should be similarly derived.

823. The United States Court of Appeals for the District of Columbia Circuit recently remanded our interim transport rules.[1951] The court concluded that the Commission had not provided sufficient justification for its method of establishing the rate level of the interstate switched access rate element for tandem switching.[1952] We do not believe, however, that the *CompTel v. FCC* decision is inconsistent with the rules we establish here because the decision did not address or criticize the Commission's determination of the rates for dedicated transport or tandem-switched transport links. Because our proxies do not involve the interstate access rate for tandem switching, they are not inconsistent with the court's analysis.

824. Tandem switching also employs shared facilities. States may, therefore, establish usage-sensitive charges to recover tandem-switching costs. For those states that cannot complete a forward-looking economic cost study within the arbitration period or cannot devote the necessary resources to such a review, we establish a default rate ceiling of 0.15 cents ($0.0015) per minute of use. The additional cost of termination at a tandem in comparison to termination at an end office consists of the cost of tandem switching and the cost of tandem-switched transport transmission. Illinois and Maryland have adopted rates for the transport and termination of traffic from the tandem switch that are, respectively, 0.25 cents ($0.0025) per minute of use and 0.2

[1949] Specifically, when the transport rate restructure was implemented, the initial levels of tandem-switched transmission rates were presumed reasonable if they were based on a weighted per-minute equivalent of direct-trunked transport DS1 and DS3 rates that reflects the relative number of DS1 and DS3 circuits used in the tandem to end office links, calculated using a loading factor of 9000 minutes per month per voice-grade circuit. 47 C.F.R. § 69.111.

[1950] *First Transport Order*, 7 FCC Rcd at 7018-19. Interstate access rates for tandem-switched transport vary by region and mileage. The average charge by RBOCs in Density Zone 1 for transport termination and one mile of switched common transport facility between a tandem switching office and end office equals 0.033 cents ($0.000331) per minute. For a five-mile facility, the average charge is 0.048 cents ($0.000479) per minute; for a ten-mile facility, 0.066 cents ($0.000664) per minute.

[1951] *Competitive Telecommunications Ass'n v. FCC*, No. 95-1168 (D.C. Cir. April 28, 1996).

[1952] The court accepted both AT&T's claim that the Commission had not justified the allocation of 80 percent of the tandem revenue requirement to the TIC and only 20 percent to the tandem element, and CompTel's argument that the Commission had not justified its allocation of overheads to the tandem element.

cents ($0.002) per minute of use, higher than rates for termination at end office switches.[1953] In both instances, our default rate ceiling for tandem switching constitutes at least 60 percent of the implicit tandem switching and transport to the end office switch. We, therefore, find the default rate ceiling we adopt for tandem switching to be consistent with both Illinois's and Maryland's adopted rates for transport and switching of traffic from the tandem office. States that use our proxy and impose flat-rated charges for tandem switching should set rates so that the price does not exceed 0.15 cents ($0.0015) per minute of use if converted through use of a geographically disaggregated usage factor.

825. Rates for signaling and database services should be usage-sensitive, based either on the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, which should be charged on a flat-rated basis. Usage charges of this type appear to reflect most accurately the underlying costs of these services.[1954] Interstate access rates for most of these elements have been justified using the price caps new services test, which roughly approximates the results of a forward-looking economic cost study.[1955] In addition, the costs of these services were forward-looking, in that the services were completely new and hence, by definition, used the best-available technology. Thus, we establish as a default proxy ceiling for these elements corresponding interstate access charges for these elements.[1956] For elements that have not been subject to the new services test, states may establish proxy ceilings by identifying the direct costs of providing the element and adding a reasonable allocation of joint and common costs. Because we expect that the joint and common costs associated with the forward-looking cost of network elements are substantially less than those associated with

[1953] Illinois Commission comments at Attachment C (Illinois Commerce Commission Docket No. 94.0096), pp.83-86, 98; Maryland Commission comments at Appendix B (Maryland Commission Order No. 72348, Case No. 8548 Phase II), pp.28-32.

[1954] *Ameritech Operating Companies Petition for Waiver of Part 69 of the Commission's Rules to Establish Unbundled Rate Elements for SS7 Signalling*, DA 96-446, Order, at para. 31 (Com. Car. Bur., rel. Mar. 27, 1996).

[1955] *Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge supplements for Open Network Architecture*, CC Docket Nos. 89-79 and 87-313, Report and Order, Order on Reconsideration, and Supplemental Notice of Proposed Rulemaking, 6 FCC Rcd 4524, 4531 (1991); *modified on recon.*, 7 FCC Rcd 5235 (1992); *Open Network Architecture Tariffs of Bell Operating Companies*, CC Docket No. 92-91, Order, 9 FCC Rcd 440, 454-456 (1993).

[1956] Interstate database services consist of Line Information Database (LIDB) and 800 Database. Deployment of SS7 (out-of-band signaling) has enabled LECs to offer these services. The average charge for RBOCs for LIDB in Density Zone 1 equals 3.34 cents ($0.034) per database query.

traditional service-based costs,[1957] allowing a reasonable allocation is sufficient to protect against possible anticompetitive pricing. Absent any proxy, this approach will provide the most reasonable approximation of forward-looking economic cost.

826. We have established rate structure rules for collocation elements in connection with our *Expanded Interconnection* proceeding.[1958] Many collocation elements established under section 251(c)(6) are likely to represent the same facilities, and should have the same cost characteristics, as existing interstate expanded interconnection services, and therefore we require states to use the same rate structure rules for those collocation elements that we established in the *Expanded Interconnection* proceeding. As a proxy ceiling, states may use the rates the LEC has in effect in its federal expanded interconnection tariff for the equivalent services. Expanded interconnection services are subject to the new services test, which, as discussed above, uses a forward-looking methodology. Although LECs have filed expanded interconnection tariffs, we have not yet completed our investigation into those tariffs. Any price for unbundled collocation elements set based on LEC expanded interconnection tariffs would therefore be subject to any modification of those tariffs that results from our pending investigation, and any state-imposed prices based on those tariffs will need to be adjusted accordingly.

827. We find it unnecessary to specify rate structures for other unbundled elements. The states shall make those determinations by applying our general rate structure principles described above. In the absence of an acceptable forward-looking cost study, states may establish default proxy ceilings for other unbundled elements by identifying the direct costs of providing the element and adding a reasonable allocation of joint and common costs.

[1957] *See supra*, Section VII.B.2.a.

[1958] *Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, 9 FCC Rcd 5154, 5186 (1994).

3. Forward-Looking Cost Model Proxies

a. Background and Comments

828. In the NPRM, we sought comment on the use of certain generic cost studies. Commenters discussed several such models. These models include: 1) the *Hatfield 2*;[1959] 2) the *Hatfield 2.2*;[1960] 3) the *BCM*;[1961] 4) the *BCM 2*;[1962] and 5) the *CPM*.[1963]

829. *Generic Cost Models.* Several generic forward-looking costing models were introduced into the record. Several commenters, supporting the use of generic cost models to establish the rates that incumbent LECs may charge for interconnection and unbundled elements, claim that such an approach would result in ceilings that are efficient, objective, and based on non-proprietary inputs.[1964] On the other hand, certain commenters argue that generic cost models should not be used as proxies because they fail to reflect the possible differences in costs among states, and among carriers, due to technical, demographic, and geographic factors.[1965] In addition, many parties also discussed the use of proxies as direct substitutes for the prices of interconnection and unbundled network element rates.[1966]

[1959] *The Cost of Basic Network Elements: Theory, Modeling, and Policy Implications* (Hatfield Associates, Inc., March 1996), submitted by MCI on March 29, 1996 (*Hatfield 2*).

[1960] *Hatfield Model, Version 2.2, Release 1*, (Hatfield Associates, Inc., March 1996), submitted by AT&T and MCI on May 16, 1996 (*Hatfield 2.2*); *see also* AT&T reply at Appendix D (Update of the Hatfield Model Version 2.2, Release 1).

[1961] *Benchmark Cost Model: A Joint Submission by MCI Communications, Inc., NYNEX Corporation, Sprint Corporation, U S West, Inc.* (December 1995), submitted by MCI Communications, Inc., NYNEX Corp., Sprint/United Management Corp., U S West, Inc. on July 24, 1996 (*BCM*).

[1962] *Benchmark Cost Model 2* (July 1996), submitted by Sprint Corp. and U S West, Inc., on July 24, 1996 (*BCM 2*).

[1963] *The Cost Proxy Model* (INDETEC International, 1996), submitted by Pacific Telesis Group on June 7, 1996 (*CPM*).

[1964] *See, e.g.*, Ad Hoc Telecommunications Users Committee comments at 50; PacTel comments at 76; Ohio Consumers' Counsel comments at 28-29.

[1965] *See, e.g.*, Bay Springs, *et al.* comments at 16-17; Cincinnati Bell comments at 28; Florida Commission comments at 30; Telecommunications Resellers Ass'n comments at 41; California Commission reply at 19.

[1966] *See, e.g.*, AT&T comments at 53.

830. *The Hatfield Models.*[1967] Parties also commented on the particular generic cost models placed on the record in this proceeding, and several support the use of a version of the *Hatfield* model.[1968] These parties argue that the *Hatfield* model represents the only comprehensive nationwide analysis of virtually all network elements on a highly disaggregated basis and is the ideal standard for the Commission to adopt because it will provide immediate certainty on pricing.[1969] Other commenters oppose the application of a version of the *Hatfield* model,[1970] asserting that it may not accurately reflect an incumbent LEC's decisionmaking process for determining the economic and technical feasibility of interconnection because it assumes building "from scratch," an assumption potentially leading to inaccuracy.[1971] Critics of the various *Hatfield* models also argue that they results in below-cost rates for services,[1972] do not capture embedded costs,[1973] and employ a nationwide industry average for costs when costs should be based on the particular carrier's costs.[1974]

831. GTE argues that the *Hatfield 2.2* model's assumptions and analytic practices result in an understatement of cost per loop of about $8.00.[1975] GTE criticizes the assumption that all traffic carried by LECs will be served by a brand new entrant that instantly materializes. GTE indicates that such an assumption would not produce results that are representative of incumbent

[1967] We note that many parties did not address their comments to a particular version of the *Hatfield* model. In such cases, we will refer generally to the *Hatfield* model.

[1968] *See, e.g.*, ACSI comments at 56; AT&T comments at 53 (commenting on *Hatfield 2.2*); MCI comments at 68-69 (commenting on *Hatfield 2*); NEXTLINK comments at 27-28; Washington Commission comments at 27.

[1969] *See, e.g.*, MCI comments at 69 (commenting on *Hatfield 2*).

[1970] *See, e.g.*, PacTel comments at 74-76, reply at 30 (commenting on *Hatfield 2.2*); Ohio Consumers' Counsel comments at 29 n.10; USTA comments at 54 n.45; Sprint reply at 31-32; Rural Tel. Coalition reply at 35.

[1971] *See, e.g.*, Florida Commission comments at 28-29; Lincoln Tel. reply at 6; Rural Tel. Coalition reply at 35; USTA comments at 47-48, 54 n.45.

[1972] *See, e.g.*, Lincoln Tel. reply at 6; U S West comments 20-22.

[1973] *See, e.g.*, USTA comments at 54 n.45; Rural Tel. Coalition reply at 35; PacTel reply at 30 (commenting on *Hatfield 2.2*).

[1974] *See, e.g.*, GVNW reply at 12-13; Lincoln Tel. reply at 6; Sprint reply at 28-32.

[1975] Letter from Whitney Hatch, Assistant Vice President Regulatory Affairs, GTE, to William F. Caton, Acting Secretary, FCC, July 11, 1996 at Attachment 2 (Economic Evaluation of Version 2.2 of the Hatfield Model).

LEC costs when providing services and unbundled elements. GTE argues that the *Hatfield 2.2* model's use of multiplicative factors to calculate installation costs produces inaccuracies, to the extent that the basis of these factors depart from historical relationships. In addition, GTE asserts that the equipment prices used in the *Hatfield 2.2* model are consistently lower than prices paid by LECs. Moreover, GTE asserts that the capital cost and depreciation rates of the *Hatfield 2.2* model do not reflect costs of capital and depreciation rates that will prevail under competitive conditions.[1976] Finally, it asserts that the *Hatfield 2.2* model uses unrealistically high fill factors (the percentage of capacity used), which results in an understatement of investment and, hence, annualized cost.[1977]

832. *The Benchmark Cost Models.*[1978] Although some parties support the use of the *BCM* to set rates for interconnection and unbundled elements,[1979] many other parties oppose its use for this purpose.[1980] Several commenters argue that, because the *BCM* was designed to identify only high cost areas, its assumptions are flawed and will fail to reflect small and rural LECs' network characteristics.[1981] NYNEX argues that the *BCM* is based on a limited set of assumptions about the costs that affect loops.[1982] Commenters further contend that the *BCM* is not technology neutral,[1983] is not designed to estimate the costs of serving business customers,[1984] assumes one

[1976] *Id.* at 13-16.

[1977] *Id.* at 9-12.

[1978] We note that many parties did not address their comments to a particular version of the *BCM*. In such cases, we will refer generally to the *BCM*.

[1979] *See, e.g.*, ACSI comments at 56; Sprint comments at 54 n.30; Texas Public Utility Counsel comments at 29.

[1980] *See, e.g.*, Florida Commission comments at 29-30; GVNW comments at 38-39; NYNEX comments at 57; Ohio Consumers' Counsel comments at 29, n.10; PacTel comments at 74-76; SBC comments at 92-93; TDS comments at 22; Rural Tel Coalition comment at 22, reply at 34-35.

[1981] *See, e.g.*, Rural Tel. Coalition comments at 22; TDS comments at 22; *see also* Time Warner comments at 54-55; USTA comments at 54 n.45.

[1982] NYNEX comments at 57; *see also* SBC comments at 92-93.

[1983] *See, e.g.*, WinStar comments at 34; Texas Statewide Tel. Cooperative, Inc. comments at 14.

[1984] *See, e.g.*, NYNEX comments at 57.

type of central office switch,[1985] and uses ARMIS cost loading factors that assume that costs are spread over the existing, larger investment base.[1986]

833. *Cost Proxy Model (CPM).* Pacific Telesis maintains that its *CPM* is a superior alternative to the *Hatfield* models and *BCM* models because it is more flexible, can be based on non-proprietary information, can be independently audited, can estimate the cost of providing local telephone service for one-fourth (1/4) mile grids or large geographic areas, and reflects the actual locale of subscribers within a census block.[1987]

b. Discussion

834. We believe that the generic forward-looking costing models, in principle, appear best to comport with the preferred economic cost approach discussed previously. Several such models were placed in the record, including *Hatfield 2*, *Hatfield 2.2*, *BCM*, *BCM 2*, and the *CPM*. The *BCM* is designed to produce "benchmark" costs for the provision of basic telephone service within specific geographic regions defined by the Bureau of the Census as Census Block Groups. The *Hatfield 2* model combines output from the *BCM* with independently-developed investment data to produce annual cost estimates for eleven basic network functions. The *CPM* is similar in structure to the *BCM* and *Hatfield 2* models, although it uses different algorithms.

835. These models appear to offer a method of estimating the cost of network elements on a forward-looking basis that is practical to implement and that allows state commissions the ability to examine the assumptions and parameters that go into the cost estimates. Although these models were submitted too late in this proceeding for the Commission and parties to evaluate them fully, our initial examination leads us to believe that the remaining practical and empirical issues can be resolved in the near future. In light of the advantages of such a generic approach, we will further examine these generic economic cost models by the first quarter of 1997 to determine whether we should use one of them to replace the default proxies we adopt in this proceeding. In that event, states would have the option of setting rates in arbitrations on the basis of an economic cost study or by using a generic forward-looking cost model approved at that time.[1988]

[1985] *Id.*

[1986] *Id.*

[1987] PacTel comments at 76.

[1988] We note that we address certain criticisms of the models in the context of their use in the development of the proxy for the unbundled local loop, *supra*, Section VII.C.2.b.(1)(b).

836. Finally, we note that Commission staff developed a model of the telecommunications industry that they designed to simulate industry demand and supply characteristics.[1989] In order to encourage an open-ended discussion of the utility of the staff model, the Common Carrier Bureau sought comment on a working draft of the model that was released. Almost all parties commenting on the staff model urged the Commission not to rely upon the staff model as record evidence in this proceeding.[1990] We are not relying on the staff model to develop the requirements imposed by this Order.

D. Other Issues

1. Future Adjustments to Interconnection and Unbundled Element Rate Levels

a. Background and Comments

837. In the NPRM, we sought comment on whether some cost index or price cap system would be appropriate to ensure that rates reflect expected changes in costs over time.[1991] Only two parties commented on this issue, and neither supported establishment of a price cap system or other index system to adjust rates over time. MCI claims that it is not necessary to recompute TSLRIC costs each year. It argues that large productivity factors are not needed as they are in price cap system, because initial access rates were based on embedded costs, which greatly exceed economic costs. MCI proposes that the Commission should use initial rates as ceilings for a three to five year period. It contends that, if competition develops satisfactorily, there may not be a need to revisit the costing process. On the other hand, MCI suggests that if it appears that LECs retain substantial market power, a performance review could become necessary.[1992] Ad Hoc Telecommunications Users Committee notes that the success of any price cap plan would depend on the accuracy of the productivity offset. It states that an inappropriately low productivity offset could result in excessive charges.[1993]

[1989] *See* Public Notice, *Supplemental Comment Period Designated for Local Competition Proceeding*, CC Docket 96-98, DA 96-1007 (rel. June 20, 1996). The comment period was extended subsequently to July 8, 1996. *See* Public Notice, *Supplemental Comment Period Extended for Local Competition Proceeding*, CC Docket 96-98, DA 96-1030 (rel. June 25, 1996). The Commission did not authorize reply comments.

[1990] *See, e.g.*, Ameritech July 8 comments at 14; NCTA July 8 comments at 2; PacTel July 8 comments at 21; *see also* New York Commission July 8 comments at 1-2 (Commission should institute "collaborative process" whereby federal, state, and industry participants can review model and develop alternatives).

[1991] NPRM at para. 133.

[1992] MCI comments at 68.

[1993] Ad Hoc Telecommunications Users Committee comments at 31.

b. Discussion

838. As noted earlier, we will continue to review our pricing methodology, and will make revisions as appropriate. Accordingly, there is no present need to establish a Commission price cap or cost index system to adjust interconnection and unbundled element rate levels.

2. Imputation

a. Background

839. We sought comment in the NPRM on whether we should require an "imputation rule" in establishing rates for unbundled network elements.[1994] An imputation rule would require that the sum of prices charged for a basket of unbundled network elements not exceed the retail price for a service offered using the same basket of elements. We further solicited comment on any other rules that could be adopted regarding pricing of unbundled network elements that would help to promote the pro-competitive goals of the 1996 Act.

b. Comments

840. Commenters favoring an imputation rule, including some IXCs and other potential entrants, and one state utility counsel, argue that imputation is necessary to prevent potential anticompetitive practices highlighted in the NPRM, such as price squeezes and predatory pricing by incumbent LECs.[1995] Several commenters also endorsed imputation as a method of testing whether rates are reasonable.[1996] Sprint argues that, unless the Commission imposes an imputation rule, incumbent LECs will have little incentive to pursue rate rebalancing activities vigorously before state commissions.[1997] Teleport urges the Commission not to assume that new entrants possess sufficient financial resources to survive a price squeeze and suggests that, if a carrier fails an imputation test, the Commission should find that the market is not sufficiently competitive to

---

[1994] NPRM at para. 184.

[1995] *See e.g.*, ACSI comments at 56-57; ACTA comments at 26; Frontier comments at 29-30; NEXTLINK comments at 33; Telecommunications Resellers Ass'n comments at 26; Teleport comments at 60-63; Texas Public Utility Counsel comments at 47-48. MCI comments at Attachment 1 (The Cost of Basic Network Elements: Theory, Modeling and Policy Implications), pp.6-7 (arguing that imputation is necessary, but not sufficient, to prevent price squeezes).

[1996] *See, e.g.*, Intermedia Comments at 14; Sprint Comments at 72-74.

[1997] Sprint reply at 44.

allow incumbent BOC entry into the in-region long distance market.[1998]

841. Among new entrants, Time Warner believes an imputation rule is unnecessary because unbundled element rates will not exceed retail rates in most cases.[1999] It asserts that the Commission should not adopt an imputation rule during the transition period prior to the enactment of universal service reform, and that it is unlikely that competing providers will ignore competitive forces and uniformly retain non-competitive margins in order to support residential rates below TSLRIC.[2000]

842. Several commenters express the view that imputation issues should be left for decision by the states.[2001] A number of state utility commissions that employ an imputation rule in their states endorse imputation as a way to prevent price squeezes, but either take no position on, or oppose, Commission adoption of imputation as a national standard.[2002] The Michigan Commission Staff believes that states should have flexibility to address imputation issues on their own, a process that has already begun in Michigan.[2003] The Washington Commission states that, although it has employed imputation as a method of ensuring that customers of monopoly services do not subsidize other more competitive services, the "threat" posed by below-cost rates generally has been overstated.[2004]

843. The National Association of State Utility Consumer Advocates and the Competition Policy Institute argue that the Commission lacks power to act in this area because of the intrastate/interstate jurisdictional divide established by section 152(b) of the Communications Act

---

[1998] Teleport comments at 60-63.

[1999] Time Warner comments at 83.

[2000] *Id.* at 84-85

[2001] *See, e.g.*, Alabama Commission comments at 28; Florida Commission comments at 38 (no need for federal imputation rule if each state may implement unbundled element pricing rules that cover costs); Wyoming Commission comments at 36.

[2002] *See, e.g.*, Colorado Commission comments at 56-57 (opposing a national imputation rule); Washington Commission comments at 35 (questioning the need for preemption order that would require that local service rates exceed costs); Illinois Commission comments at 56-58 (urging the Commission not to prohibit states from adopting imputation rules, but taking no position on the need for a national imputation rule pending further study by the federal-state joint board).

[2003] Michigan Commission Staff comments at 16-17.

[2004] Washington Commission comments at 36.

of 1934.[2005]

844. Responding to the concern, expressed in the NPRM, about requiring imputation for below-cost services, the Texas Commission observes that Texas law will permit waiver of its imputation rule in certain cases.[2006] Frontier states that in the case of subsidized services a limited offset could be applied to reflect the subsidy, but only in the uncommon case in which the incumbent LEC can affirmatively prove that the affected class of service is priced below its forward-looking incremental cost.[2007]

845. Joint Consumer Advocates and the Ohio Commission suggest that adoption of an imputation rule is unnecessary because both the incumbent LEC and the new entrant will face the same burdens in providing below cost service, and each may recover their costs through other revenue sources, such as federal and state universal service funds.[2008] Joint Consumer Advocates and Ohio Consumers' Counsel take issue with the assumption that local service is subsidized, and argue imputation is unnecessary because retail rates are not significantly below cost.[2009] They assert that since other services, such as toll, also use the local loop, it is improper to load all of the costs of the local loop onto local service.[2010]

846. Several commenters voice concerns that an imputation rule would be difficult to implement in rural areas.[2011] The Minnesota Independent Coalition states that imputation could lead to increases in local rates for rural service, in contravention of the 1996 Act's universal service requirements of preserving rates in rural areas that are reasonably comparable to rates charged for similar services in urban areas, and the universal service policy requirements of

---

[2005] Competition Policy Institute comments at 13; Natl. Ass'n of State Util. Consumer Advocates comments at 5-8; Joint Consumer Advocates reply at 14.

[2006] Texas Commission comments at 29-30, Attachment II (Public Util. Regulatory Act of 1995, Tex. Rev. Civ. Stat. Ann., Art. 1446(c)) (Texas law requires the Texas Commission to adopt imputation rules by December 1, 1996).

[2007] Frontier comments at 29-30.

[2008] Joint Consumer Advocates reply at 15-16; Ohio Commission comments at 67.

[2009] Joint Consumer Advocates reply at 14-16; Ohio Consumers' Counsel comments at 38-40.

[2010] *Id.*

[2011] *See, e.g.*, TCA Comments at 8.

254(b).[2012]

847. Incumbent LECs also oppose imputation, claiming that it would create opportunities for arbitrage,[2013] fail to reflect the costs of unbundling incumbent LEC networks,[2014] put pressure on states to raise retail rates,[2015] create a de facto ceiling preventing incumbent LECs from recovering their costs,[2016] and constitute an unconstitutional taking of incumbent LEC revenues.[2017] NYNEX and BellSouth also assert that restrictions on cost recovery are inconsistent with the 1996 Act's requirement that unbundled element rates be based on costs.[2018] According to USTA and Ameritech, an imputation rule may cause incumbent LECs to subsidize new entrants, and lead to inefficient entry.[2019] BellSouth argues that intrastate retail prices are based on factors other than cost, such as the policies of the state commission that approved the charges, and that an imputation rule would interfere with the states' exclusive ratemaking authority over intrastate rates and charges. According to BellSouth, Congress did not establish any requirement or expectation that these pricing standards would yield charges that would bear any particular relationship to one another, and BellSouth asserts there is no reason to expect the sum of unbundled element prices to add up to the retail rate any more than one would expect that the individual parts of an automobile could be obtained for less than the price of an already-assembled car. [2020]

[2012] Minn. Ind. Coalition comments at 31, 33; *see also* Western Alliance comments at 3-4 (Commission should not adopt an imputation rule until other, explicit mechanisms are in place to ensure the statutory goal of reasonable parity of urban and rural rates).

[2013] *E.g.*, USTA comments at 75.

[2014] *See, e.g.*, Ameritech comments at 83-84 (rejecting a "sum-of-the-parts" test for unbundled element pricing, and arguing that an imputation rule must make allowance for costs of unbundling the network); GTE comments at 64-65.

[2015] *E.g.*, USTA comments at 77.

[2016] *E.g.*, NYNEX comments at 60 (asserting that such a price ceiling conflicts with the 1996 Act).

[2017] *See, e.g.*, NYNEX comments at 60-61; USTA comments at 77, reply at 31.

[2018] BellSouth reply at 42; NYNEX comments at 61.

[2019] Ameritech comments at 84; USTA comments at 77.

[2020] BellSouth comments at 68; *see also* US Network Services comments at 5-6.

c. Discussion

848. Although we recognize, as several commenters observe, that an imputation rule could help detect and prevent price squeezes, we decline to impose an imputation requirement. Adoption of an imputation rule could force states to engage in a major rate rebalancing effort at this time, because it would impose substantial additional burdens on states at a time when they will need to devote significant resources to implementing the 1996 Act.

849. In addition to our practical concerns regarding implementation of an imputation rule, we find that an imputation rule may not be necessary to achieve the pro-competitive goals of the 1996 Act. As some commenters, including several state commissions, suggest, competing providers may be able to provide basic service, at less than the cost of facilities and associated management, just as incumbent LECs do currently, by selling customers higher profit vertical or intrastate toll services, or through receipt of access revenues and subsidies. Further, the Ohio Consumers' Counsel suggest that below-cost rates may not be sufficiently prevalent to justify a national imputation rule.[2021] The Joint Consumer Advocates and the Ohio Consumers' Counsel question whether local service is, in fact, underpriced.[2022]

850. We give special weight to the comments of several state commissions that currently employ imputation rules.[2023] These state commissions endorse imputation as a tool to prevent price squeezes, but urge us only to provide states with the flexibility to adopt imputation rules. We agree with those state commission commenters that argue that nothing in the 1996 Act prohibits individual states from adopting imputation rules. While an imputation rule may be pro-competitive, we will leave the implementation of such rules to individual states for the time being.

[2021] Ohio Consumers' Counsel comments at 39.

[2022] Joint Consumer Advocates reply at 16; Ohio Consumers' Counsel comments at 39.

[2023] *See, e.g.*, Colorado Commission comments at 56-57; Illinois Commission comments at 57-58; Michigan Commission Staff comments at 16-17; Washington Commission comments at 35.

3. Discrimination

a. Background

851. In the NPRM, we noted the different usages of the term "discrimination" in the 1996 Act and the 1934 Act.[2024] Sections 251 and 252 require that interconnection and unbundled element rates be "nondiscriminatory."[2025] Similarly, section 251(c)(4) requires that, in making resale available, carriers not impose "discriminatory conditions or limitations on resale."[2026] Finally, section 252(e) provides that states may reject a negotiated agreement or a portion of the agreement if it "discriminates" against a carrier not a party to the agreement and section 252(i) requires incumbent LECs to "make available any interconnection, service, or network element provided under an agreement . . . to which it is a party to any requesting telecommunications carrier upon the same terms and conditions."[2027] In contrast, section 202(a) of the 1934 Act provides that "(i)t shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges . . . for . . . like communication service."[2028]

852. We sought comment on "the meaning of the term 'nondiscriminatory' in the 1996 Act compared with the phrase 'unreasonable discrimination' in the 1934 Act." We asked specifically whether Congress intended to prohibit all price discrimination, including measures such as density zone pricing or volume and term discounts, by choosing the word "nondiscriminatory." We further asked whether sections 251 and 252 could be interpreted to prohibit only unjust or unreasonable discrimination. Finally, we sought comment on whether the 1996 Act prohibited carriers from charging different rates to parties that are not similarly situated.[2029]

[2024] NPRM at para. 155.

[2025] 47 U.S.C. §§ 251(c)(2), (3), (6), and 252(d)(1).

[2026] 47 U.S.C. § 251(c)(4)(B). *See infra*, Section VIII.C..

[2027] 47 U.S.C. §§ 252(e), (i).

[2028] 47 U.S.C. § 202(a).

[2029] NPRM at para. 156.

b. Comments

853. Many state regulatory commissions, several incumbent LECs, and USTA maintain that the term "nondiscriminatory" used in the 1996 Act is synonymous with the prohibition of "unjust and unreasonable discrimination" used in the 1934 Act.[2030] Generally, these parties agree that pricing variations are only discriminatory when the affected parties are similarly situated. They argue that a blanket prohibition on all price differences, even when justified by costs, would be anti-competitive and would appear to defeat the process of negotiation. The Ohio Commission argues that smaller companies, not similarly situated to the larger telephone companies already in operation, need different treatment in order to compete.[2031] Finally, they contend that Congress did not intend to prohibit reasonably supported plans, such as volume and term discounts. The Pennsylvania Commission argues that, if Congress had intended to prohibit cost-based price differences, it would have included interconnection and unbundled elements in the prohibition against geographic price differences for toll rates, which is contained in Section 254(g).[2032] Pacific Telesis argues that different prices are permissible under the "nondiscriminatory" standard wherever incremental costs decline as output increases.[2033]

854. Other commenters, including MCI and MFS, assert that the term "nondiscriminatory" in the 1996 Act must be interpreted to have a more stringent meaning than the phrase "unjust and unreasonable discrimination" used in the 1934 Act.[2034] Several parties suggest that since the conferees considered and rejected a version of section 251 that applied an "unreasonably discriminatory" standard to the actions of incumbent LECs, the change in wording was purposeful.[2035] Generally, these parties argue that although the "nondiscriminatory" standard

---

[2030] *See, e.g.*, Alabama Commission comments at 23; BellSouth comments at 58; California Commission comments at 31-33; Colorado Commission comments at 48; District of Columbia Commission comments at 25; Illinois Commission comments at 47; Indiana Commission comments at 25; MECA comments at 55-56; Ohio Commission comments at 51; PacTel comments at 76-77; USTA comments at 57-58.

[2031] Ohio Commission comments at 53.

[2032] Pennsylvania Commission comments at 32.

[2033] PacTel comments at 77; *but see* AT&T reply at 35.

[2034] *See, e.g.*, MCI comments at 71; MFS comments at 63; ALTS reply at 40.

[2035] NCTA comments at 31 n.114 (*citing* S. 652, 104th Cong. 1st Sess. § 101 (deleting Section 251(c)(2)(C)) (Draft, Nov. 27, 1995)); *see also* MFS comments at 63.

is more stringent, cost-based price differences are nonetheless permissible under the 1996 Act.[2036] The Independent Cable & Telecommunications Association contends that the only way to prevent incumbent LECs from discriminating against smaller companies and new entrants is to prohibit all non-cost based price differences.[2037] LDDS argues that only cost-based price differentials should be permitted, and that any non-cost-based volume discount should be prohibited, even if arrived at through agreement of the parties.[2038]

855. A third group of commenters argue for a strict reading of the term "nondiscriminatory."[2039] They argue that the plain meaning of the term "nondiscriminatory" without qualification demonstrates that under section 251 even reasonable discrimination is impermissible.[2040] R. Koch contends that if there is *any* discrimination, small entrants will be at a disadvantage.[2041] Finally, they maintain that the higher standard reflects the distinction between the carrier-user relationship being regulated in section 202(a) and the intercarrier relationship addressed in section 251(c).[2042]

856. CMRS providers argue that some state regulations treat CMRS providers differently than wireline new entrants with respect to the rates for interconnection with incumbent LECs. AT&T Wireless contends that the New York and Connecticut Commissions require incumbent LECs to charge two distinct interconnection rates depending on whether the carrier is classified as a CMRS provider or competing provider of local exchange service.[2043] According to AT&T Wireless, in New York, the wireline competitive LEC rate for termination of traffic on the incumbent LEC network is less than one cent per minute and the CMRS provider rate is

---

[2036] *See, e.g.*, MCI comments at 71-72; MFS comments at 64; Michigan Commission comments at 18; Municipal Utilities comments at 14-15; Pennsylvania Commission comments at 32; Sprint comments at 64-65.

[2037] Ind. Cable & Telecomm. Ass'n reply at 11-12.

[2038] LDDS reply at 40-41.

[2039] *See, e.g.*, AT&T comments at 68-69; NCTA comments at 31 (section 251(c) requires strict scrutiny of any discrimination, not solely unreasonable discrimination); WinStar comments at 7.

[2040] *See, e.g.*, WinStar comments at 7.

[2041] *See, e.g.*, R. Koch comments at 3.

[2042] NCTA comments at 31.

[2043] Letter from Cathleen A. Massey, AT&T Wireless Services, to William F. Caton, Acting Secretary, FCC, July 2, 1996, filed in CC Docket Nos. 95-185 and 96-98, at 1-3 (*AT&T July 2, 1996 Ex Parte*).

approximately 2.6 cents ($0.026) per minute.[2044] AT&T Wireless further contends that, in order to obtain the lower rate, a CMRS provider in New York must comply with state regulations, such as universal service obligations associated with residential and Lifeline service.[2045] Bell Atlantic NYNEX Mobile submits that in Connecticut, the rate for wireline new entrants' termination of traffic on the incumbent LEC network is less than one cent ($0.01) per minute and the CMRS provider rate is 4.14 cents ($0.0414) per minute.[2046] AT&T Wireless states that California has ordered incumbent LECs to implement interim bill-and-keep compensation for interconnection for wireline entrants' interconnection but not for CMRS providers' interconnection,[2047] and Florida has ruled that no compensation shall be paid to mobile carriers by incumbent LECs for land-originated calls.[2048]

857. In addition to their assertion regarding rate discrimination, CMRS providers maintain that state commissions permit incumbent LECs to treat CMRS providers in a discriminatory manner with respect to the terms and conditions of interconnection.[2049] Bell Atlantic NYNEX Mobile states that in Connecticut, Maryland, New York and Texas, the rates paid by Bell Atlantic NYNEX Mobile to the connecting LEC to terminate calls originated on Bell Atlantic NYNEX Mobile's network are more than twice the rates paid by competing wireline LECs to incumbent LECs.[2050] Bell Atlantic NYNEX Mobile also states that "these disparities have no rational cost

---

[2044] *Id.*

[2045] *See Order Instituting Framework for Directory Listings, Carrier Interconnection and Carrier Compensation*, New York Public Service Commission, CASE 94-C-0095 (New York Commission, September 27, 1996) at 15.

[2046] Bell Atlantic NYNEX Mobile comments in CC Docket No. 95-185, at Exhibit A.

[2047] *Competition For Local Exchange Service*, Decision 95-07-054, Appendix A, para. 7 (California Commission, July 24, 1995).

[2048] *See Investigation Into the Rates For Interconnection of Mobile Service Providers With Facilities of Local Exchange Companies*, Docket No. 940235-TL, slip op. at 24 (Florida Commission, Oct. 11, 1995).

[2049] AT&T comments in CC Docket No. 95-185, at 27; AirTouch Communications comments in CC Docket No. 95-185, at 33; Bell Atlantic NYNEX Mobile comments in CC Docket 95-185, at 5-6; Comcast Corporation comments in CC Docket No. 95-185, at 6-7; New Par comments in CC Docket No. 95-185, at 4-5.

[2050] Bell Atlantic NYNEX Mobile comments in CC Docket No. 95-185, at Exhibit A, p.5. Bell Atlantic NYNEX Mobile's Exhibit A shows that LEC charges to competitive providers on an average rate per minute are considerably less than those to CMRS carriers: In Connecticut, Bell Atlantic NYNEX Mobile pays 4.14 cents/min. ($0.0414) to terminate local traffic on a LEC network while competitive providers pay 0.8 cents/min. ($0.008); in Maryland, Bell Atlantic NYNEX Mobile pays 2.27 cents/min. ($0.0227) to terminate local traffic on a LEC network, while competitive providers pay 0.5 cents/min. ($0.005); in New York, Bell Atlantic NYNEX

basis since an incumbent LEC's costs to complete a call received from Bell Atlantic NYNEX Mobile should be no higher than its costs to complete calls received from other carriers."[2051] Similarly, APC states that its interconnection agreements with Bell Atlantic, which are identical in Maryland, Virginia, West Virginia, and District of Columbia, artificially inflate its costs by at least 3.1 cents ($0.031) per minute.[2052]

858. Western Wireless also provides examples of discriminatory interconnection rates by LECs.[2053] Western Wireless states that it has been unable to reach an agreement with any incumbent LECs in its wireless service area that is based on cost or that provides reciprocal compensation.[2054] AT&T Wireless contends that states regularly permit LECs to charge wireless carriers significantly higher rates than competing LECs for intrastate interconnection.[2055] CTIA cites LEC-LEC interconnection agreements in 18 states that provide for rates much below the approximate nationwide average incumbent LEC-CMRS interconnection rate of three cents ($0.03) per minute.[2056]

Mobile pays 2.59 cents/min. ($0.0259) to terminate local traffic on a LEC network, while competitive providers pay only 0.98 cents/min.; and in Texas, Bell Atlantic NYNEX Mobile pays 1.7 cents/min. ($0.017) to terminate local traffic on a LEC network, while competitive providers pay zero cents/min. ($0.0). *Id.*

[2051] *Id.* at 5-6.

[2052] APC comments in CC Docket No. 95-185 at 5-6 (alleging it pays Bell Atlantic a monthly $25 per trunk surcharge between its mobile switching center and Bell Atlantic's tandem, a usage-sensitive charge for transport and switching elements, and $800 a month for termination for SS7 connectivity, while Bell Atlantic pays APC nothing in return).

[2053] Letter from Doane F. Kiechel, counsel to Western Wireless Corporation, to William F. Caton, Acting Secretary, FCC, July 5, 1996, in CC Docket No. 96-98.

[2054] *Id.* at 4.

[2055] *AT&T July 2, 1996 Ex Parte* at 3.

[2056] Letter from Randall S. Coleman, CTIA, to Michele Farquhar, Chief, Wireless Telecommunications Bureau, FCC, July 2, 1996, in CC Docket Nos. 95-185 and 96-98, at Attachments.

c. Discussion

859. We conclude that the term "nondiscriminatory" in the 1996 Act is not synonymous with "unjust and unreasonable discrimination" in section 202(a), but rather is a more stringent standard.[2057] Finding otherwise would fail to give meaning to Congress's decision to use different language. We agree, however, with those parties that argue that cost-based differences in rates are permissible under sections 251 and 252.

860. Section 252(d)(1), for example, requires carriers to base interconnection and network element charges on costs. Where costs differ, rate differences that accurately reflect those differences are not discriminatory. This is consistent with the economic definition of price discrimination, which is "the practice of selling the same product at two or more prices where the price differences do not reflect cost differences . . . An important feature of the economic definition of price discrimination is that it occurs not only when prices are different in the presence of similar costs but also *when the prices are the same and the costs of supplying customers are different.*" [2058] As one economist has recognized, differential pricing is "one of the most prevalent forms of marketing practices" of competitive enterprises.[2059] Strict application of the term "nondiscriminatory" as urged by those commenters who argue that prices must be uniform would itself be discriminatory according to the economic definition of price discrimination. If the 1996 Act is read to allow no price distinctions between companies that impose very different interconnection costs on LECs, competition for all competitors, including small companies, could be impaired. Thus, we find that price differences, such as volume and term discounts, when based upon legitimate variations in costs are permissible under the 1996 Act, if justified.

861. On the other hand, price differences based not on cost differences but on such considerations as competitive relationships, the technology used by the requesting carrier, the nature of the service the requesting carrier provides, or other factors not reflecting costs, the requirements of the Act, or applicable rules, would be discriminatory and not permissible under the new standard. Such examples include the imposition of different rates, terms and conditions based on the fact that the competing provider does or does not compete with the incumbent LEC, or offers service via wireless rather than wireline facilities. We find that it would be unlawfully discriminatory, in violation of sections 251 and 252, if an incumbent LEC were to charge one

---

[2057] *See supra,* Section IV.G, discussing nondiscriminatory terms and conditions for interconnection, and *supra,* Section V.G., discussing nondiscriminatory terms and conditions for unbundled network elements.

[2058] David L. Kaserman & John W. Mayo, Government & Business: *The Economics of Antitrust & Regulation* at 273-74 (1995) (*citing* George J. Stigler, *The Theory of Price* (3d ed. 1966)) (emphasis added).

[2059] Hal R. Varian, "Price Discrimination," in *Handbook of Industrial Organization,* vol.1, p. 598 (R. Schmalensee and R.D. Willig eds., 1989).

class of interconnecting carriers, such as CMRS providers, higher rates for interconnection than it charges other carriers, unless the different rates could be justified by differences in the costs incurred by the incumbent LEC.

862. State regulations permitting non-cost based discriminatory treatment are prohibited by the 1996 Act. This conclusion is consistent with both the letter and the spirit of the 1996 Act and our determination that the pricing for interconnection, unbundled elements, and transport and termination of traffic should not vary based on the identity or classification of the interconnector.[2060]

[2060] *See infra*, Section XI.A., discussing transport and termination rates.

VIII. RESALE

863. Section 251(c)(4) imposes a duty on incumbent LECs to offer certain services for resale at wholesale rates. Specifically, section 251(c)(4) requires an incumbent LEC:

> (A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and
>
> (B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.[2061]

864. The requirement that incumbent LECs offer services at wholesale rates is described in section 252(d)(3), which sets forth the pricing standard that states must use in arbitrating agreements and reviewing rates under BOC statements of generally available terms and conditions:

> [A] State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

Section VIII.A. of this Order discusses the scope of section 251(c)(4). Section VIII.B. addresses the determination of "wholesale rates." Section VIII.C. considers the issue of conditions or limitations on resale under this section, Section VIII.D. discusses the resale obligations under section 251(b)(1), and Section VIII.E. considers the application of access charges in the resale environment.

[2061] 47 U.S.C. § 251(c)(4).

A. Scope of Section 251(c)(4)

1. Background and Comments

865. In the NPRM, we sought comment generally on the scope of section 251(c)(4).[2062] AT&T and MCI request that the Commission adopt a minimum list of services that should be available for resale under section 251(c)(4).[2063] Cable & Wireless, the Telecommunications Resellers Association, and others argue for an expansive definition of "telecommunications services."[2064] For example, MCI argues that we should explicitly identify the following as telecommunications services that must be made available for resale: measured-rate business, flat-rate business, measured-rate residential, flat-rate residential; custom calling features (including all CLASS services); call blocking services; voice messaging; Integrated Services Digital Network (ISDN), Basic Rate Interface (BRI), and Primary Rate Interface (PRI); flat-rated and measured trunk services (including all types of PBX trunks); Automatic Number Identification (ANI) over T-1; data services; promotions, optional calling plans, special pricing plans; calling card, directory services, operator services; intraLATA toll; public access line service; semi-public coin telephone service; foreign exchange services; video dialtone; and Centrex and all feature packages.[2065]

866. Incumbent LECs on the other hand, argue for a much more limited set of services, primarily those generally thought of as basic telephone services.[2066] For example, SBC lists the following as examples of services that should be excluded: billing and collection; enhanced billing products; enhanced white page listings; inside wire; BDS/LAN; customer premises equipment; and information services.[2067]

867. Some commenters argue that parties seeking discounted telecommunications services for their own telephony needs should not be allowed to purchase services at wholesale prices. For example, Roseville Telephone argues that (1) requests for discounted resale services must come from carriers, not from end users; (2) a wholesale customer must resell 95 percent of the

[2062] NPRM at para. 173.

[2063] AT&T comments at 77 n.113; MCI comments at 84.

[2064] Cable & Wireless comments at 38-39; Telecommunications Resellers Ass'n comments at 18 n.47; AT&T comments at 76-78; MCI comments at 84.

[2065] MCI comments at 84.

[2066] *See, e.g.*, MECA comments at 60; NYNEX comments at 76-7; SBC reply at 13.

[2067] SBC comments at 67-68.

services it purchases at wholesale prices to unaffiliated companies; and (3) limits should be placed on how much of what wholesale service is sold to any one subscriber.[2068] Similarly, GTE argues that new entrants must resell service they purchase under section 251(c)(4) and not simply use such services for their own internal or administrative purposes.[2069] Cincinnati Bell requests that we explicitly state that resellers of incumbent LEC service must be telecommunications carriers.[2070] Conversely, AT&T opposes predicating the ability to purchase services at wholesale rates on the percentage of customers that purchase the resold service.[2071]

868. Some parties address the application of section 251(c)(4) to the services incumbent LECs sell to independent public payphone providers. The American Public Communications Council contends that independent public payphone providers are not "telecommunications carriers."[2072] The American Public Communications Council cites the definition in section 3(44) that excludes "aggregators," as defined in section 226[2073] and points out that we have previously found that independent public payphone providers are aggregators insofar as they exercise control over payphones.[2074] Thus, the American Public Communications Council argues, services sold to independent public payphone providers by incumbent LECs would be "telecommunications service[s] that [an incumbent LEC] provides at retail to subscribers who are not telecommunications carriers," thereby making such services subject to section 251(c)(4).[2075] The American Public Communications Council also argues that nothing in section 251 requires an entity purchasing services for resale to be a "telecommunications carrier."[2076] NYNEX argues that

[2068] Roseville Tel. comments at 3-5.

[2069] GTE comments at 47.

[2070] Cincinnati Bell comments at 31.

[2071] AT&T comments at 80 n.120.

[2072] American Public Communications Council comments at 2-3.

[2073] 47 U.S.C. § 153(44). Section 226(a)(2) defines "aggregator" as "any person that, in the ordinary course of its operations, makes telephones available to the public or to transient users of its premises, for interstate telephone calls using a provider of operator services. 47 U.S.C. § 226(a)(2).

[2074] American Public Communications Council comments at 2 (citing *Policies and Rules Concerning Operator Service Providers, Report and Order*, 6 FCC Rcd 2744 (1991), *recon.* 7 FCC Rcd 3882 (1992)).

[2075] American Public Communications Council at 3.

[2076] *Id.*

independent public payphone providers do not purchase these services for resale, but for their own use.[2077] Additionally, NYNEX argues, independent payphone providers do not interpose themselves between incumbent LECs and their existing retail customers, and thus do not enable incumbent LECs to avoid some portion of costs they incur in dealing with those customers.[2078] MFS argues that no resale relationship exists between an incumbent LEC and an independent public payphone provider.[2079]

869. Parties dispute whether specially-priced bundles of services must be offered for resale. SNET argues that LECs are not required to resell bundled services, as long as the services are all offered separately. SNET contends that requiring wholesale offerings of bundled services would deter competitive offerings by incumbent LECs.[2080] SBC argues that bundled services are not single services and therefore not subject to the resale provisions of the 1996 Act.[2081] The Telecommunications Resellers Association, TCC, LDDS, and MCI take the opposite position,[2082] noting that bundled items are often sold at prices well below the sum of their stand-alone prices.

870. The Telecommunications Resellers Association and Cable & Wireless argue that, where the incumbent LEC offers services only on a bundled basis, these services should be unbundled and offered separately, at wholesale rates.[2083] AT&T specifically argues that it should be allowed to purchase local exchange service without operator services.[2084] Pacific Telesis, NYNEX, and NCTA argue that incumbent LECs should not be subject to this requirement so long as the services are not offered to retail customers on a stand-alone basis.[2085] Bell Atlantic opposes AT&T's claim that Bell Atlantic should be required to provide local service without

[2077] NYNEX reply at 39.

[2078] *Id.*

[2079] MFS reply at 32.

[2080] SNET comments at 34.

[2081] *Id.* at 72-73.

[2082] Telecommunications Resellers Ass'n comments at 18; TCC comments at 44; LDDS comments at 83; MCI comments at 89.

[2083] *See, e.g.*, Telecommunications Resellers Ass'n comments at 19 n.49; Cable & Wireless comments at 48.

[2084] AT&T comments at 81 n.123.

[2085] PacTel comments at 87; NYNEX comments at 73; NCTA comments at 57.

operator services for resale.[2086]

2. Discussion

871. Section 251(c)(4)(A) imposes on all incumbent LECs the duty to offer for resale "any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers."[2087] We conclude that an incumbent LEC must establish a wholesale rate for each retail service that: (1) meets the statutory definition of a "telecommunications service;" and (2) is provided at retail to subscribers who are not "telecommunications carriers."[2088] We thus find no statutory basis for limiting the resale duty to basic telephone services, as some suggest.

872. We need not prescribe a minimum list of services that are subject to the resale requirement. State commissions, incumbent LECs, and resellers can determine the services that an incumbent LEC must provide at wholesale rates by examining that LEC's retail tariffs. The 1996 Act does not require an incumbent LEC to make a wholesale offering of any service that the incumbent LEC does not offer to retail customers. State commissions, however, may have the power to require incumbent LECs to offer specific intrastate services.[2089]

873. Exchange access services are not subject to the resale requirements of section 251(c)(4). The vast majority of purchasers of interstate access services are telecommunications carriers, not end users. It is true that incumbent LEC interstate access tariffs do not contain any limitation that prevents end users from buying these services, and that end users do occasionally purchase some access services, including special access,[2090] Feature Group A,[2091] and certain

[2086] Bell Atlantic reply at 25.

[2087] 47 U.S.C. § 251(c)(4)(A).

[2088] "Telecommunications service" is defined in section 3(46) to mean "the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used." 47 U.S.C. § 153(46) "Telecommunications" is, in turn, defined in section 3(43) as "the transmission, between or among points specified by the user, of information of the user's choosing without change in the form or content of the information as sent and received." 47 U.S.C. § 153(43). "Telecommunications carrier" is defined in section 3(44) to mean "any provider of telecommunications services, except that such term does not include aggregators of telecommunications services (as defined in section 226)." 47 U.S.C. § 153(44).

[2089] *See, e.g.*, Illinois Public Utilities Act, Section 13-505.5.

[2090] End users may purchase special access from incumbent LECs in order to use high volume services offered by IXCs, such as AT&T's Megacom service.

Feature Group D elements for large private networks.[2092] Despite this fact, we conclude that the language and intent of section 251 clearly demonstrates that exchange access services should not be considered services an incumbent LEC "provides at retail to subscribers who are not telecommunications carriers" under section 251(c)(4). We note that virtually all commenters in this proceeding agree, or assume without stating, that exchange access services are not subject to the resale requirements of section 251(c)(4).[2093]

874. We find several compelling reasons to conclude that exchange access services should not be subject to resale requirements. First, these services are predominantly offered to, and taken by, IXCs, not end users. Part 69 of our rules defines these charges as "carrier's carrier charges,"[2094] and the specific part 69 rules that describe each interstate switched access element refer to charges assessed on "interexchange carriers" rather than end users.[2095] The mere fact that fundamentally non-retail services are offered pursuant to tariffs that do not restrict their availability, and that a small number of end users do purchase some of these services, does not alter the essential nature of the services. Moreover, because access services are designed for, and sold to, IXCs as an input component to the IXC's own retail services, LECs would not avoid any "retail" costs when offering these services at "wholesale" to those same IXCs. Congress clearly intended section 251(c)(4) to apply to services targeted to end user subscribers, because only those services would involve an appreciable level of avoided costs that could be used to generate a wholesale rate. Furthermore, as explained in the following paragraph, section 251(c)(4) does not entitle subscribers to obtain services at wholesale rates for their own use. Permitting IXCs to purchase access services at wholesale rates for their own use would be inconsistent with this requirement.

875. We conclude that section 251(c)(4) does not require incumbent LECs to make

[2091] Feature Group A is similar to a local exchange service, but is used for interstate access. In such circumstances, the end user dials a seven-digit number to reach the LEC's "dial tone office" serving an IXC, where the LEC switches the call to the IXC's POP via a dedicated line-side connection. Feature Group A represents approximately one percent of incumbent LEC transport revenues.

[2092] Feature Group D is the set of elements through which IXCs today almost universally purchase switched access services from incumbent LECs.

[2093] *See, e.g.*, Cincinnati Bell comments at 34; Citizens Utilities comments at 25; NYNEX comments at 35 n.70; Rural Tel. Coalition comments at 20; J. Staurulakis comments at 6; SBC reply at 13; USTA reply at 31; Wisconsin Commission comments at Attachment, pp. 7-8.

[2094] 47 U.S.C. § 69.5(b).

[2095] The one exception, as discussed below, is the SLC, which is assessed on end users regardless of who purchases the access services from the incumbent LEC.

services available for resale at wholesale rates to parties who are not "telecommunications carriers" or who are purchasing service for their own use. The wholesale pricing requirement is intended to facilitate competition on a resale basis. Further, the negotiation process established by Congress for the implementation of section 251 requires incumbent LECs to negotiate agreements, including resale agreements, with "requesting telecommunications carrier or carriers,"[2096] not with end users or other entities. We further discuss the definition of "telecommunications carrier" in Section IX. of the Order.

876. With regard to independent public payphone providers, however, we agree with the American Public Communication Council's argument that such carriers are not "telecommunications carriers" under section 3(44). We therefore also agree with the American Public Communications Council's contention that the services independent public payphone providers obtain from incumbent LECs are telecommunications services that incumbent LECs provide "at retail to subscribers who are not telecommunications carriers" and that such services should be available at wholesale rates to telecommunications carriers. Because we conclude that independent public payphone providers are not "telecommunications carriers," however, we conclude that incumbent LECs need not make available service to independent public payphone providers at wholesale rates. This is consistent with our finding that wholesale offerings must be purchased for the purpose of resale by "telecommunications carriers."

877. We conclude that the plain language of the 1996 Act requires that the incumbent LEC make available at wholesale rates retail services that are actually composed of other retail services, *i.e.*, bundled service offerings. Section 251(c)(4) states that the incumbent LEC must offer for resale "any telecommunications service" provided at retail to subscribers who are not telecommunications carriers. The resale provision of the 1996 Act does not contain any language exempting services if those services can be duplicated or approximated by combining other services. On the other hand, section 251(c)(4) does not impose on incumbent LECs the obligation to disaggregate a retail service into more discrete retail services. The 1996 Act merely requires that any retail services offered to customers be made available for resale.

B. Wholesale Pricing

1. Background

878. As discussed above, section 251(c)(4) requires incumbent LECs to offer at "wholesale rates" any telecommunications services that the carrier provides at retail to subscribers who are not telecommunications carriers. Section 252(d)(3) establishes the standard that states must use in determining wholesale rates in arbitrations or in reviewing wholesale rates under BOC statements of generally available terms and conditions. Specifically, section 252(d)(3) provides that wholesale rates shall be set "on the basis of retail rates charged to subscribers for

[2096] 47 U.S.C.§ 252(a)(1).

the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier."[2097]

879. In the NPRM, we generally sought comment on the meaning of the term "wholesale rates" in section 251(c)(4).[2098] We asked if we could and should establish principles for the states to apply in order to determine wholesale prices in an expeditious and consistent manner. We also sought comment on whether we should issue rules for states to apply in determining avoided costs. We stated that we could, for example, determine that states are permitted under the 1996 Act to direct incumbent LECs to quantify their costs for any marketing, billing, collection, and similar activities that are associated with offering retail, but not wholesale, services.[2099] We also sought comment on whether avoided costs should include a share of common costs and general overhead or "markup" assigned to such costs. LECs would then reduce retail rates by this amount, offset by any portion of expenses that they incur in the provision of wholesale rates.[2100] We noted that this approach appeared to be consistent with the 1996 Act, but would create certain administrative difficulties because all of the information regarding costs is under the control of the incumbent LECs.[2101] We also asked for comment on several alternative approaches. For example, we asked whether we could establish a uniform set of presumptions regarding avoided costs that states could adopt and that would apply in the absence of a quantification of such costs by incumbent LECs.[2102] Additionally, we asked whether we should identify specific accounts or portions of accounts in the Commission's Uniform System of Accounts ("USOA")[2103] that the states should include as avoided costs.[2104] We also requested comment on whether we should

[2097] 47 U.S.C. § 252(d)(3).

[2098] NPRM at para. 179.

[2099] *Id.* at para. 180.

[2100] *Id.*

[2101] *Id.*

[2102] *Id.* at para. 181.

[2103] 47 C.F.R. § 32.

[2104] NPRM at para. 181.

establish rules that allocate avoided costs across services.[2105] We asked whether incumbent LECs should be allowed,
or required, to vary the percentage wholesale discounts across different services based on the degree the avoided costs relate to those services.[2106] Finally, we asked whether we should adopt a uniform percentage discount off of the retail rate of each service.[2107]

2. Comments

880. Most commenters other than incumbent LECs and some states advocate establishment of national pricing rules regarding arbitrated rates for competitors' acquisition of services for resale under section 251(c)(4).[2108] Incumbent LECs and state commissions argue that we do not have the authority to establish such rules and, even assuming such authority exists, we should not exercise it.[2109] Bay Springs, *et al.*, GVNW, and the Rural Telephone Coalition argue that establishing national wholesale pricing rules would insufficiently recognize differences in LECs' operations, resulting in inadequate compensation for small incumbent LECs.[2110]

881. Many commenters preface their arguments concerning wholesale discounts calculation with a general discussion of the role of resale in creating a competitive local exchange market. IXCs and resellers argue that resale is the quickest method of developing ubiquitous competition and therefore encourage the Commission to adopt of national rules that would result

[2105] *Id.* at para. 182.

[2106] *Id.*

[2107] *Id.*

[2108] *See, e.g.*, AT&T comments at 82; Cable & Wireless comments at 37; CompTel comments at 96; MFS comments at 72; LCI comments at 31; Telecommunications Resellers Ass'n comments at 24; Teleport comments at 55-56; TCC comments at 45.

[2109] *See, e.g.*, BellSouth comments at 67; SBC comments at 74; District of Columbia Commission comments at 32; Pennsylvania Commission comments at 37.

[2110] Bay Springs, *et al.*, comments at 17; GVNW comments at 40; Rural Tel. Coalition comments at 21. For example, the Rural Telephone Coalition points out that setting a national wholesale discount based on certain assumed levels of marketing expenses overstates avoided costs for small and rural incumbent LECs because such carriers face less competition and therefore have fewer marketing expenses. Rural Telephone Coalition comments at 21. Similarly, Bay Springs, *et al.*, GVNW, and the Rural Telephone Coalition argue that smaller incumbent LECs will not be able to avoid as many shared costs because their smaller staffing and operational functions are less responsive to the overall size of the carriers' operations. Bay Springs, *et al.*, comments at 17; GVNW comments at 40; Rural Tel. Coalition comments at 21.

in substantial wholesale discounts.[2111] AT&T argues that a discount that does not permit viable competition should be presumed unreasonable.[2112] Cable & Wireless and the Telecommunications Resellers Ass'n point out that resale will be a particularly important market entry strategy for small businesses that cannot afford the investments necessary to construct their own facilities or purchase unbundled elements.[2113]

882. Incumbent LECs, cable companies, CAPs, and Sprint generally argue for low wholesale discounts.[2114] Facility-based competitors and potential competitors, such as MFS and cable operators, argue that we should focus our efforts on encouraging facilities-based competition. Such parties, including incumbent LECs, claim that large resale discounts will discourage the development of facilities by making it unnecessary for a new entrant to construct its own facilities in order to compete effectively on the basis of price.[2115] MFS and GTE state that wholesale pricing should only be applied in the absence of facilities-based competition and that once such competition exists, we should forbear from imposing wholesale pricing on incumbent LEC services offered for resale.[2116] Incumbent LECs, cable operators, and Sprint oppose AT&T's proposal that discounts that do not permit viable competition should be presumed unreasonable.[2117]

883. Parties favoring national rules regarding resale differ as to the form such rules should take. Some propose that we establish a methodology for calculating avoided costs. For

[2111] *See, e.g.*, AT&T reply at Appendix E (Avoided Cost Model); Cable & Wireless comments at 38.

[2112] AT&T comments at 85.

[2113] Cable & Wireless at 35; Telecommunications Resellers Ass'n at 15. The Competition Policy Institute similarly argues that resale will bring both large and small (resale) carriers into the market. Competition Policy Institute comments at 24.

[2114] *See, e.g.*, GTE reply at 25-26; NYNEX comments at 40-41; NCTA comments at 23; TCI comments at 8; MFS reply at 34-36, Sprint reply at 41.

[2115] *See, e.g.*, NCTA comments at 29-30; Comcast comments at 21; Cox comments at 32; Time Warner comments at 70; MFS comments at 72; U S West comments, Exhibit A (Federal Implementation of the Telecommunications Act of 1996) at 26; BellSouth comments at Attachment (Interconnection and Economic Efficiency), p. 19; Bell Atlantic comments at Attachment (Declaration of Robert W. Crandall), pp. 4-5.

[2116] This forbearance would be pursuant to 47 U.S.C. § 160. MFS comments at 72 n.80; GTE reply at 26 n.44.

[2117] *See, e.g.*, Bell Atlantic reply at 24; Time Warner reply at 22; Sprint reply at 40.

example, certain parties advocate a rule requiring the use of long-run incremental cost.[2118] Others advocate some form of proxies or presumptions to determine avoided costs. NEXTLINK argues that the Commission should establish a uniform set of presumptions regarding the types of costs that are to be avoided and require that calculations of avoided costs be based on publicly available sources.[2119] NEXTLINK contends that these requirements would allow rapid identification of avoided costs and should lead to the development of presumptive percentage discounts that will apply to retail rates.[2120]

884. Incumbent LECs and MFS also argue that "avoided" costs are those that are actually avoided by such carriers instead of costs that are theoretically "avoidable."[2121] GTE argues that an "avoidable" standard improperly measures avoided costs in the long run versus actually avoided costs.[2122] IXCs and resellers argue that the standard should be "avoidable" costs; otherwise, incumbent LECs will be able to game their accounting systems and business practices to minimize actually "avoided" expense.[2123]

885. A number of parties propose that this Commission specify various USOA accounts as avoided costs.[2124] Several parties introduced models or studies that use accounting data to calculate wholesale discounts. These proposals are summarized in detail in the next section.

[2118] *See, e.g.*, GSA/DoD comments at 11.

[2119] NEXTLINK comments at 33.

[2120] *Id.* Also, the Telecommunications Resellers Ass'n advocates establishing a minimal discount, to which states may add, but not delete, unless they petition the FCC for express exemption. Telecommunications Resellers Ass'n comments at 24-25.

[2121] *See, e.g.*, GTE reply at 25-26; NYNEX comments at 81; SBC reply at 15 n.35; USTA reply at 30; MFS comments at 72.

[2122] *See* Rebuttal Testimony of Douglas E. Wellemeyer, *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, R. 93-04-003 and I. 93-04-002 (California Commission July 10, 1996), submitted as attachment to Letter from Whitney Hatch, Assistant Vice President--Regulatory Affairs, GTE, to John Nakahata, Senior Legal Advisor, Chairman Reed E. Hundt, FCC, July 18, 1996.

[2123] *See, e.g.*, AT&T comments at 84 n.129; Cable & Wireless reply at 29.

[2124] *See* AT&T comments at 83-84 n.130-131; GCI comment at 15; MCI comments at Attachment 2 (Pricing of Wholesale Services); TCC comments at 45-46; Telecommunications Resellers Ass'n comments at 25-26; Sprint comments at Appendix C. While not providing specific USOA accounts, several parties encourage the Commission to identify these accounts. *See, e.g.*, ACSI comments at 61.

886. Some parties recommend that we adopt a specific percentage discount from the retail rate. For example, the Massachusetts Attorney General recommends an interim discount of 25 percent until carrier-specific cost studies can be performed.[2125] ACTA suggests that we adopt a 25 percent discount as a national standard.[2126] Several cable interests recommend ten percent maximum discounts, at least until avoided cost studies can be performed.[2127] The Telecommunications Resellers Association suggests that discounts in the range of 30 to 50 percent off the retail rate are necessary to allow resellers to provide competition.[2128] AT&T argues that, whatever discount is selected, states should be allowed to increase it to promote competition.[2129] Furthermore, AT&T argues that states should be allowed to impose penalties in the form of increased discounts for failure to provide service of equivalent quality offered to incumbent LEC customers or to provide electronic interfaces to the incumbent LEC network.[2130] Incumbent LECs and MFS argue that the 1996 Act does not authorize the service quality penalties or competition-enhancing increased discounts suggested by AT&T.[2131]

887. MFS, Teleport, Time Warner, the Massachusetts Commission, and a number of incumbent LECs argue that joint, common, and overhead costs should not be included in the calculation of avoided costs.[2132] They argue that these costs are not avoided because they will continue to be incurred in providing wholesale service. AT&T, MCI, and others favor inclusion of a portion of joint, common, and overhead costs in avoided costs because these costs will decrease as the overall level of operations of an incumbent LEC decrease (as a result of

[2125] Mass. Attorney General comments at 24.

[2126] ACTA comments at 31-32.

[2127] *See, e.g.*, Comcast comments at 21; NCTA comments at 41.

[2128] Telecommunications Resellers Ass'n comments at 24.

[2129] AT&T comments at 84.

[2130] *Id.* at 84-85.

[2131] *See, e.g.*, MFS reply at 36; Bell Atlantic reply at 24; Sprint reply at 42.

[2132] *See, e.g.*, MFS comments at 74; Teleport comments at 56-57; Time Warner comments at 77; Mass. Commission comments at 14-15; Ameritech comments at 80; BellSouth comments at 67; Cincinnati Bell comments at 35; GTE comments at 51; Lincoln Tel. reply at 8; U S West comments at 68-69; PacTel comments at 90; Rural Tel. Coalition reply at 15; USTA comments at Attachment (Affidavit of Jerry A. Hausman), p. 11.

downscaling their retail operations).[2133]

888. There is significant disagreement about whether wholesale rates should take into account any additional costs incumbent LECs incur in providing wholesale service, such as those relating to wholesale marketing and billing operations. Incumbent LECs, facilities-based competitors, Sprint, and others argue that wholesale rates must include such costs to ensure recovery from the cost-causing parties -- resellers.[2134] Some incumbent LECs note that these additional costs could also be recovered through a separate charge.[2135] IXCs and resellers argue that the plain language of the section 252(d)(3) does not provide for the recognition of these costs.[2136] They also add that allowing incumbent LECs to recover these costs from resellers discourages efficiency in their wholesale operations.[2137]

889. A number of incumbent LECs oppose application of a single percentage discount rate for all services, arguing that avoided costs will vary among different services.[2138] Some state commissions also recommend against adoption of a uniform rate.[2139] MFS argues that, because section 252(d)(3) refers to retail rates charged to subscribers "for the telecommunications service requested," a uniform wholesale discount rate would frustrate Congressional intent.[2140] Advocates of a uniform discount, however, contend that incumbent LECs will be able to game any system involving a nonuniform allocation of avoided cost, because the information regarding such costs

[2133] *See, e.g.*, TCC comments at 45-46; AT&T reply at Appendix E (Avoided Cost Model); MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 9; Texas Public Utility Counsel comments at 45-46.

[2134] *See, e.g.*, Ameritech comments at 80; Bell Atlantic comments at 44-45; BellSouth comments at Attachment (Interconnection and Economic Efficiency), p. 20; Citizens Utilities comments at 25; USTA comments at Attachment (Affidavit of Jerry A. Hausman), p.12, reply at 29; MFS comments at 73-74; Teleport comments at 57; Time Warner comments at 78; Ohio Commission comments at 59-60, 66; Sprint comments at 72; J. Staurulakis comments at 10.

[2135] *See, e.g.*, BellSouth comments at 67; NYNEX comments at 83.

[2136] *See, e.g.*, AT&T reply at 10; LDDS reply at 45; TCC comments at 47; Cable & Wireless reply at 28-29; Telecommunications Resellers Ass'n reply at 18.

[2137] LDDS reply at 45. LDDS argues that such costs should be recovered in a competitively-neutral manner. *Id.*

[2138] *See, e.g.*, Bell Atlantic comments at 46; USTA comments at 74-75; MFS comments at 73.

[2139] *See, e.g.*, California Commission comments at 37-38.

[2140] MFS comments at 73.

is under their control.[2141] Advocates of a uniform discount also argue that apportioning avoided costs over specific services can be difficult, while a uniform rate is simple to apply. Ameritech argues that the wholesale rate structure of an incumbent LEC should not mirror its retail rate structure. Rather, it should be based on a weighted average of all retail rates provided by the incumbent LEC, less avoided cost.[2142]

3. The Models and Study

890. MCI and AT&T introduced models, and Sprint submitted a study for calculating wholesale rates. This section describes each of these proposals and summarizes the criticisms directed against them. AT&T and MCI offer models which, they contend, can be used to generate discount rates for each incumbent LEC's retail offerings. As an example of the avoided cost approach Sprint advocates, Sprint submits a study based on its United Telephone subsidiary operations in Tennessee.[2143]

891. MCI's model uses publicly available USOA data.[2144] MCI analyzes three categories of avoided cost: (1) marketing, billing, and collection costs; (2) "other costs"; and (3) common costs allocated to avoided cost activities. MCI identifies the following USOA accounts as avoided marketing, billing, and collection costs:

Account 6611 (product management)
Account 6612 (sales)
Account 6613 (product advertising)
Account 6621 (call completion services)
Account 6622 (number services)
Account 6623 (customer services)
Account 6722 (external relations)
Account 6727 (research and development)

[2141] *See, e.g.*, Cable & Wireless comments at 47; TCC comments at 47, Telecommunications Resellers Ass'n reply at 18-19; NEXTLINK comments at 33.

[2142] Ameritech comments at 58. For example, this would average various time-of-day plans and usage plans.

[2143] Sprint comments at Appendix C (Avoided Cost Study: Tennessee United Telephone–S.E., Inc.).

[2144] MCI comments at Attachment 2 (Pricing of Wholesale Services).

MCI treats as "other" avoided costs all of the expenses recorded in the following accounts:

Account 6113 (aircraft expense)
Account 6341 (large PBX expense)
Account 6351 (public telephone terminal equipment expense)
Account 6511 (property held for future telecommunications use)
Account 6512 (provisioning expense)
Account 6562 (depreciation expense--property held for future telecommunications use)
Account 6564 (amortization expense--intangible)

MCI's model also allocates to avoided cost activities a portion of the general overhead and general support expenses recorded in the following accounts:

general overhead
Account 6711 (executive)
Account 6712 (planning)
Account 6721 (accounting and finance)
Account 6723 (human resources)
Account 6724 (information management)
Account 6725 (legal)
Account 6726 (procurement)
Account 6728 (other general and administrative)
Account 6790 (provision for uncollectible notes receivable)

general support
Account 6121 (land and building expense)
Account 6122 (furniture and artworks expense)
Account 6123 (office equipment expense)
Account 6124 (general purpose computers expense)

MCI uses an iterative process to determine separate avoided cost percentages for general overhead costs and for general support costs.[2145] The resulting percentages are based on the relative ratios

[2145] The formulae used by MCI in calculating certain overhead and general support costs are dependent on variables affected by the result of the calculation of such costs. Iteration is a means of solving for variables in such circumstances.

of avoided costs to total operating expense.[2146] MCI's model assumes that incumbent LECs incur no additional expenses in providing wholesale services.

892. After total avoided costs are determined, MCI subtracts the total avoided costs from total operating expenses to derive total wholesale expenses. MCI then calculates wholesale service revenue using a formula that allows the incumbent LEC the same proportional mark-up above costs on wholesale services as on its retail services.[2147] The formula sets the ratio of total revenue less total expenses to total revenue (retail markup) equal to the ratio of wholesale revenue less wholesale expenses to wholesale revenues (allowable wholesale markup) then computes wholesale revenue (and rates) by solving for that variable in a simple equation.[2148] MCI computes a wholesale discount rate as one minus the ratio of wholesale revenue over total revenue. Wholesale rates are computed by reducing retail rates by the wholesale discount.

893. MCI proposes that states use its model to calculate a single wholesale discount rate for each incumbent LEC that would apply in every state in which that incumbent LEC does business and for all services the incumbent LEC provides for resale. States would apply that rate

---

[2146] Total Avoided Expense = [Not Avoided Expenses * 0%] + [Totally Avoided Expenses * 100%] + [Partially Avoided Expenses * a%] + [Partially Avoided Expenses * b%]

Where:

$$a = \%\ \text{Corporate Operations Avoidable} = \frac{\text{Total Avoided Expenses}}{\text{Total Expenses - Depreciation \& Amortization Expense}}$$

$$b = \%\ \text{General Support Avoidable} = \frac{\text{Total Avoided Expenses}}{\text{Total Expenses - General Support}}$$

[2147] $$\text{Wholesale Price Discount} = 1 - \frac{\text{Wholesale Service Revenue}}{\text{Total Operating Revenue}}$$

Where:

$$\text{Wholesale Service Revenue} = \frac{\text{Total Wholesale Expenses}}{(1 - \text{Base Margin})}$$

Total Wholesale Expenses = Total Operating Expenses - Total Avoided Costs

$$\text{Base Margin} = \frac{\text{Total Operating Revenue - Total Operating Expenses}}{\text{Total Operating Revenue}}$$

[2148] $$\frac{\text{Retail Revenue - Total Expenses}}{\text{Retail Revenue}} = \frac{\text{wholesale revenue - (total expenses - avoided expenses)}}{\text{wholesale revenue}}$$

$$\text{Wholesale Revenue} = \text{Retail Revenue} - \left[\text{Avoided expenses} \times \left[\frac{\text{Retail Revenue}}{\text{Total Expenses}}\right]\right]$$

This is as compared to: Wholesale Revenue = Retail Revenue - Avoided Expenses

to each of the incumbent LECs' retail services. For the seven BOCs and GTE, MCI's calculated wholesale discount factors range from 25 to 35 percent.[2149] MCI suggests that its study be declared presumptively valid by the Commission, but suggests that the Commission allow states to adopt a different resale discount by showing that the model does not produce an accurate result.[2150]

894. Sprint, several incumbent LECs, and potential facilities-based entrants, criticize the MCI model. Lincoln Telephone faults the underlying MCI study for relying on a sample of only eight companies, arguing that the limited sample does not capture the variety of billing, costing and collecting arrangements of all existing carriers.[2151] Several incumbent LECs, although not criticizing the MCI study specifically, oppose any approach that utilizes USOA accounts,[2152] or calculates the resale discount by deducting avoidable, as opposed to actually avoided, costs.[2153] Others attack MCI's method of computing wholesale rates once avoided costs are measured.[2154] MFS argues that there is no statutory basis for MCI's use of a formula that removes the markup associated with avoided retail expenses from the retail rates.[2155]

895. AT&T's avoided cost model is similar to MCI's model in that it is an embedded cost approach that starts with publicly-available accounting data.[2156] AT&T's model, however, involves several additional layers of calculations. The model assigns incumbent LEC Automated Record Management Information Systems (ARMIS) revenue and expense data to five lines of business (units). For the local business unit, which it uses as the applicable unit for resale under section 251(c)(4), avoidable expenses are computed by USOA account. AT&T argues that all of

---

[2149] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 12.

[2150] MCI comments at 90.

[2151] Lincoln Tel. comments at 8-9.

[2152] *See, e.g.*, BellSouth reply at 41; PacTel reply at 45-46.

[2153] *See, e.g.*, SBC reply at 15; NYNEX reply at 40; Ameritech reply at 37-39.

[2154] MFS reply at 36.

[2155] *Id.* This was also a point debated by incumbent LECs in various state proceedings. *See, e.g., Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company*, Nos. 95-0458 and 95-0531 (consol.) (Illinois Commission June 26, 1996) at 5-20. Teleport argues that the Illinois Commission's decision to include a portion of profit contribution was incorrect. Teleport comments at 59.

[2156] AT&T reply at Appendix E (Avoided Cost Model).

the costs associated with the following USOA accounts categories should be excluded as avoided costs, many of which are summary accounts and subsume a set of other accounts:

Account 5300 (uncollectibles)
Account 6220 (operator systems expense) (if appropriate)
Account 6533 (testing expense)
Account 6534 (plant operations administration expense)
Account 6610 (marketing expense)
Account 6620 (customer service expense)

AT&T further argues that the portion of the following USOA accounts associated with the incumbent LEC's retail operations should be excluded as avoided costs:

Account 6110 (network support expense)
Account 6120 (general support expense)
Account 6560 (depreciation expense)
Account 6710 (executive and planning expense)
Account 6720 (general and administrative expense)
Account 7240 (operating other taxes)
Account 7540 (other interest deductions)

AT&T also recommends partial avoidance of "Total Returns," which refers to portions of the retail rate that contributes to an incumbent LEC's earnings. Ultimately, under AT&T's model, the sum of avoided direct and indirect retail costs is divided by the local service-related revenues to derive the avoided cost discount. AT&T applies its model to each state, with the exception of Alaska, and derives discount rates that range from 23 percent to nearly 56 percent. Parties did not have an opportunity to comment specifically on the AT&T model during the pleading cycle of this proceeding because it was submitted with AT&T's reply. However, AT&T identified in its initial comments the list of fully and partially avoided USOA accounts that were ultimately used in its model. Criticisms of these classifications of fully and partially avoided costs are discussed below.

896. Sprint submits a sample study of its LEC subsidiary operations in Tennessee as an example of how the avoided cost approach advocated by Sprint would be applied.[2157] It was undertaken at the request of the Tennessee Commission to be used under the 1996 Act for calculating wholesale costs. Specifically, the study examines rates for resale of bundled services, focusing on those categories of costs defined in the 1996 Act (marketing, billing, collection, and other costs). Sprint describes its study as employing an activity-based cost approach that identifies the avoided cost by cost category and assigns these costs to service groups, based on a computed factor that assigns each specific type of expense to the activity that creates or drives

[2157] Sprint comments at Appendix C (Avoided Cost Study: Tennessee United Telephone--S.E., Inc.).

that expense. Sprint does not provide the worksheets detailing this cost assignment because Sprint considers the worksheets to be proprietary. Costs are identified at the subaccount level. Sprint computes the percentage of avoided costs of providing simple access service at wholesale as a percentage of simple access revenue to be 4.76 percent. Sprint computes a 7.19 percent figure for other services. In its reply comments, Sprint suggests that the AT&T and MCI models significantly overstate incumbent LEC avoided costs.

897. Parties also commented on the specific USOA accounts that should be used to identify avoided costs. We summarize below the comments with respect to the various accounts:

Marketing expenses--Account 6611 (product management), Account 6612 (sales), and Account 6613 (product advertising):

Resellers and most IXCs, other than Sprint, all support identification of these accounts as completely avoidable, both because they are explicitly mentioned in the 1996 Act and because these expenses would not be necessary in a wholesale operation.[2158] Incumbent LECs, Sprint, MFS, and Time Warner argue that expenses recorded in these accounts would, in fact, be incurred in connection with the provision of wholesale services such as marketing to wholesalers.[2159]

Services expenses--Account 6621 (call completion services), Account 6622 (number services), and Account 6623 (customer services):

IXCs and resellers contend that all of the expenses recorded in these accounts should be treated as avoidable costs because a reseller will either purchase these services separately or provide them itself.[2160] Incumbent LECs and Sprint argue that these services have no relation to local retail service and therefore cannot be included in avoided costs used to compute wholesale local service rates.[2161]

[2158] *See, e.g.*, Cable & Wireless comments at 46 n.77; Telecommunications Resellers Ass'n comments at 25-26; AT&T comments at 84 n.130; CompTel comments at 96-97; MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 5-6.

[2159] *See, e.g.*, Ameritech reply at 38; Bell Atlantic reply at 23; GTE reply at 25 n.40; MFS reply at 35; Time Warner reply at 21; USTA reply at 30; Sprint reply at 38.

[2160] *See, e.g.*, AT&T comments at 84 n.130; MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 6; Cable & Wireless comments at 46 n.77; Telecommunications Resellers Ass'n comments at 25-26. CompTel states that such accounts should be avoided where appropriate. CompTel comments at 96-97.

[2161] *See, e.g.*, Bell Atlantic reply at 23 (with respect to account 6623); USTA reply at 30 (account 6623 includes costs devoted to customer service relating to interexchange service); Sprint reply at 38-39 (also identifies account 6623 as relating to separately billed services). PacTel agrees that costs of directory

Information origination/termination expenses and other property, plant and equipment expenses--Account 6341 (large PBX expense), Account 6351 (public telephone terminal equipment expense), Account 6511 (property held for future telecommunications use), and Account 6512 (provisioning expense):

MCI and Cable & Wireless identify accounts 6341 (large PBX expense), 6351 (public telephone terminal equipment expense), 6511 (property held for future telecommunications use) and 6512 (provisioning expense) as completely avoidable,[2162] while incumbent LECs, MFS and Sprint argue that these expenses are not associated with retail activities.[2163]

Account 6220 (operator systems expense):

AT&T, TCC, and GCI argue that this account is wholly avoidable where resellers choose not to purchase operator services[2164] while Sprint argues that the account is unrelated to local service.[2165]

Account 6790 (provision for uncollectible notes receivable)/5300 (uncollectible revenue):

AT&T, TCC, and GCI argue that the sum recorded in account 5300 represents a revenue offset that is wholly avoidable.[2166] MCI chooses to measure uncollectibles using account 6790, arguing that expenses in this account are partially avoidable.[2167] Sprint and Time Warner disagree with the contention that uncollectibles are avoidable at all, claiming that uncollectibles may actually increase in a wholesale operation.[2168]

---

assistance call allowances, directory listing, and telephone directories will continue to be incurred. PacTel reply at 46.

[2162] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 8; Cable & Wireless comments at 46 n.77.

[2163] MFS reply at 35-36; Sprint reply at 38; GTE reply at 25 n.40 (at least with respect to accounts 6341 and 6351).

[2164] AT&T reply at Appendix E (Avoided Cost Model); TCC comments at 45 n.45; GCI comments at 1.

[2165] Sprint reply at 38.

[2166] AT&T comments at 84 n.130; AT&T reply, Appendix E (Avoided Cost Model); TCC comments at 45 n.45; GCI comments at 1.

[2167] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 9.

[2168] Sprint reply at 37; Time Warner reply at 21.

Network support expenses (Accounts 6112-6116):

AT&T, TCC, GCI, and the Telecommunications Resellers Association assert that all of these accounts are partially avoidable.[2169] MCI only discusses account 6113 (aircraft expense), identifying it as completely avoidable because it is not related to wholesale services.[2170] Sprint and MFS disagree, arguing that there is no evidence that costs in these accounts will decrease with wholesale offerings because these expenses will have to continue to be incurred.[2171]

General support expenses (Accounts 6121-6124) and Account 6711 (executive), Account 6712 (planning), and Accounts 6721-6728 (general and administrative expenses):

Resellers and IXCs contend that the shared expenses recorded in these accounts are partially avoidable.[2172] MCI and Cable & Wireless identify accounts 6722 (external relations) and 6727 (research and development) as completely avoidable.[2173] MCI argues that overhead costs support all of the activities, including the activities that are avoided when services are sold at wholesale. Therefore, according to MCI, a portion of overhead expenses must be treated as avoided cost.[2174] AT&T argues that wholesaling will necessarily lead to an overall reduction in the size of an incumbent LEC's operations and thus to a reduction in shared expenses.[2175] Sprint and Time Warner argue that there is no evidence to support a conclusion that resale will lead to a general reduction in shared expenses.[2176]

[2169] AT&T comments at 84 n.131; TCC comments at 46 n.46; GCI comments at 1; Telecommunications Resellers Ass'n comments at 25-26.

[2170] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 8.

[2171] MFS reply at 35 (only discusses account 6113); Sprint reply at 39-40.

[2172] *See, e.g.*, Telecommunications Resellers Ass'n comments at 25-26; AT&T comments at 84 n.131.

[2173] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 6-7; Cable & Wireless comments at 47 n.79.

[2174] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 9.

[2175] AT&T reply, Appendix E (Avoided Cost Model) at 2.

[2176] Sprint reply at 39-40; Time Warner reply at 21

Depreciation and amortization expenses (Accounts 6561-6565) and operating taxes (Accounts 7220-7240):

Resellers and IXCs also argue to varying degrees that such expenses are partially avoidable.[2177] MCI and Cable & Wireless argue for the complete avoidance of accounts 6562 (depreciation expense--property held for future telecommunications use) and 6564 (amortization expense--intangible).[2178] MFS, Sprint, and Time Warner argue that these costs will continue to be incurred for wholesale operations.[2179]

Other partially avoided accounts:

AT&T, TCC, and GCI argue that accounts 6533 (testing expenses), 6534 (plant operations administration expense), and 7540 (other interest), and total returns are partially avoidable[2180] while Sprint disagrees.[2181]

4. State Decisions

898. Several state commissions have already made interim or final determinations with respect to wholesale rates. Some, like the California and Maryland commissions, did not purport to apply or interpret the 1996 Act. Others, including the Illinois and Georgia commissions, explicitly applied section 252(d)(3) in reaching their decisions. Post-1996 Act state decisions announced to date are summarized below.

899. *California:* The California Commission adopted interim rules, effective March 31, 1996, for the resale of local exchange services by competitive LECs within the areas served by Pacific and GTE.[2182] Although the record in that proceeding was closed before the passage of the 1996 Act, the California Commission applied a "retail rates minus avoided cost" standard similar

[2177] *See, e.g.*, Telecommunications Resellers Ass'n comments at 25-26; AT&T comments at 84 n.131; CompTel comments at 97.

[2178] MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 9; Cable & Wireless comments at 47 n.79.

[2179] MFS reply at 35-36 (account 6564 is not related to retail); Sprint reply at 39-40; Time Warner reply at 21.

[2180] AT&T comments at 84 nn.130-31; TCC comments at 46 n.46; GCI comments at 1. Sprint does not comment on account 7540.

[2181] Sprint reply at 39-40.

[2182] *Order Instituting Rulemaking on the Commission's Own Motion into Competition for Local Exchange Service*, R. 95-04-043 and I. 95-04-044 (California Commission April 26, 1996). Although the final order was not issued until April 26, 1996, it became effective March 31, 1996.

to that contained in section 252(d)(3) for purposes of setting interim rates. The California Commission used an embedded cost study and USOA accounting data to calculate business discounts rates of 17 percent for PacTel and 12 percent for GTE. Because it had previously found that residential rates were already below direct embedded cost, the California Commission applied to residential services a reduced discount rate of 10 percent for PacTel and 7 percent for GTE. In arriving at this conclusion, the California Commission considered uncollectibles, marketing, and customer service expenses to be partially avoidable, to varying degrees.

900. *Colorado:* The Colorado Commission established a business discount rate of 16 percent and a residential discount rate of 9 percent.[2183] Using Colorado-specific embedded cost information previously filed by U S West as part of an annual report to that commission, the Colorado Commission calculated avoided costs for five categories of services. The Colorado Commission treated the following costs as totally avoided: uncollectibles; direct expense associated with operator services; customer operations (product management, sales, and product advertising); call completion; and number services. The Colorado Commission also considered 95 percent of the costs of customer services to be avoidable. General purpose computer expense and related depreciation, and general corporate overheads, were treated as partially avoided. The Colorado Commission concluded that wholesale discounts should be as follows: residential, 9 percent; business, 16 percent; toll services, 30 percent; central office-based features, 50 percent; all other services, 18 percent.

901. *Georgia:* The Georgia Commission established a 20.3 percent discount rate for wholesale residential service and a 17.3 percent discount rate for wholesale business service.[2184] The Georgia Commission used embedded cost information to calculate avoided direct expenses. The Georgia Commission also found that a percentage of general support, administrative, and corporate operations expenses should be considered avoided costs. In computing its final discounts, the Georgia Commission apportioned total avoided expense between residential and business services according to BellSouth's revenues for the two categories. Prior to such apportionment, the Georgia Commission's discount was 18.74 percent.

902. *Illinois:* The Illinois Commission released an order on June 26, 1996, setting wholesale discount rates for Ameritech and Centel local exchange services.[2185] The Illinois Commission applied the section 252(d)(3) pricing standard, but rejected use of embedded cost

[2183] *U S West Communications, Inc. Filing Advice Letter No. 2610 in Compliance with Commission Decision No. C96-521 Adopting Emergency Rules*, Docket No. 96S-233T (Colorado Commission June 21, 1996).

[2184] *Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms, and Conditions and Initiate Unbundling of Services*, Docket No. 6352U (Georgia Commission June 21, 1996).

[2185] *Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company*, Nos. 95-0458 and 95-0531 (consol.) (Illinois Commission June 26, 1996).

studies as inconsistent with the Commission's established cost of service rules. Instead, the Illinois Commission based its analysis on a methodology that begins with retail rates, then subtracts: (1) the "total assigned cost" of retail functions; and (2) a *pro rata* share of contribution attributable to the avoided retail costs. Total assigned costs include the long-run incremental costs of a service plus some shared and administrative costs. Contribution is the difference between retail price and long-run incremental cost. The Illinois Commission expects that this methodology, when applied to individual Ameritech services using the carrier's most recently-filed cost studies, will produce an average discount rate of 20.07 percent.[2186] The Illinois Commission applied the same rate to Centel, pending completion by Centel of the cost studies needed to apply the Illinois Commission's adopted methodology.

903. *Louisiana:* The Louisiana Commission established regulations concerning resale of telecommunications services on March 15, 1996.[2187] As an interim measure, until the Louisiana Commission can determine wholesale rates based on TSLRIC cost studies, the commission has set wholesale rates at the incumbent LEC's current tariffed retail rates minus 10 percent. This calculation reflects the incumbent LEC's avoidance of retail costs, including but not limited to, sales, marketing and customer services associated with the resold items.

904. *Maryland:* The Maryland Commission adopted, without analyzing cost studies, an interim discount rate of 10 percent, pending completion of the instant rulemaking proceeding.[2188]

905. *New York:* The New York Commission established temporary wholesale discounts for NYNEX and Rochester Telephone on July 18 of this year.[2189] The New York Commission calculates for NYNEX a 17 percent discount for residential service and an 11 percent discount for business service. Separate avoided cost percentages were derived for different shared expense categories, ranging from five percent for general and administrative expenses to 12.7 percent for

[2186] The Illinois Commission notes that the pricing methodology that it adopted would yield an average discount of 20.07 percent if applied at the individual service level and 16.63 percent if applied to the "family" service level. *Id.* at 10. Illinois decided that the individual service application avoided certain pricing anomalies and was more consistent with the 1996 Act. *Id.* at 20.

[2187] *In re: Regulations for Competition in the Local Telecommunications Market*, Docket U-200883 (Louisiana Commission March 15, 1996).

[2188] *Wholesale Rates for Telecommunications Services Ruling on AT&T's Petition for a Reduction on the Wholesale Rates of Bell Atlantic–Maryland, Inc.*, Case No. 8721 (Maryland Commission June 27, 1996).

[2189] *Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corporation, WorldCom, Inc. d/b/a LDDS WorldCom and the Empire Association of Long Distance Telephone Companies, Inc. Against New York Telephone Company Concerning Wholesale Provisioning of Local Exchange Service by New York Telephone Company and Sections of New York Telephone's Tariff No. 900*, Case 95-C-0657 (New York Commission July 18, 1996); *Petition of Rochester Telephone Corp. for Approval of a Proposed Restructuring Plan*, Case 93-C-0103 (New York Commission July 18, 1996).

network support expense. For marketing categories, 20 percent of product management, 50 percent of sales, and 50 percent of advertising expenses were considered avoidable. All uncollectibles were considered avoidable. Calculating these and other avoided costs, the New York Commission arrived at a 15 percent discount. Because the New York Commission observed that business lines produce higher overall revenue and thus artificially inflate avoided cost for business lines (and undervalue the avoided cost for residential lines), a 17 percent discount was set for residential service while only an 11 percent discount was set for business service. A uniform 13.5 percent discount was ordered for Rochester Telephone, based on a New York Commission analysis of Rochester's 1995 annual report, using principles similar to those applied to NYNEX.

906. *Ohio*: The Ohio Commission has established rules for pricing wholesale services for resale, but has not publicly released calculations of specific discounts for particular services.[2190] The Ohio Commission established a presumption that all expenses contained in the following USOA accounts will be avoided: 5300 (uncollectible revenue), 6611 (product management), 6612 (sales), 6613 (product advertising), 6621 (call completion service), 6622 (number services expense), and 6623 (customer service).[2191] The Ohio Commission's rules require resellers seeking to avoid additional costs to prove that such costs would be avoided in wholesale operations. Beyond the avoided expenses discussed above, the Ohio Commission requires avoided costs to include "direct and indirect costs of all activities eliminated due to the wholesale provisioning."

5. Discussion

907. Resale will be an important entry strategy for many new entrants, especially in the short term when they are building their own facilities. Further, in some areas and for some new entrants, we expect that the resale option will remain an important entry strategy over the longer term. Resale will also be an important entry strategy for small businesses that may lack capital to compete in the local exchange market by purchasing unbundled elements or by building their own networks. In light of the strategic importance of resale to the development of competition, we conclude that it is especially important to promulgate national rules for use by state commissions in setting wholesale rates. For the same reasons discussed in Section II.D of the Order, we believe that we have legal authority under the 1996 Act to articulate principles that will apply to the arbitration or review of wholesale rates. We also believe that articulating such principles will promote expeditious and efficient entry into the local exchange market. Clear resale rules will create incentives for parties to reach agreement on resale arrangements in voluntary negotiations. Clear rules will also aid states in conducting arbitrations that will be administratively workable

[2190] *Commission Investigation Relative to the Establishment of Local Exchange Competition and Other Competitive Issues*, Case No. 95-845-TP-COI (Ohio Commission June 12, 1996).

[2191] The Ohio Commission also lists account 6610, which is the summary account for marketing expenses (accounts 6611-6613).

and will produce results that satisfy the intent of the 1996 Act. The rules we adopt and the determinations we make in this area are crafted to achieve these purposes. We also note that clear resale rules should minimize regulatory burdens and uncertainty for all parties, including small entities and small incumbent LECs.[2192]

908. The statutory pricing standard for wholesale rates requires state commissions to (1) identify what marketing, billing, collection, and other costs will be avoided by incumbent LECs when they provide services at wholesale; and (2) calculate the portion of the retail prices for those services that is attributable to the avoided costs. Our rules provide two methods for making these determinations. The first, and preferred, method requires state commissions to identify and calculate avoided costs based on avoided cost studies. The second method allows states to select, on an interim basis, a discount rate from within a default range of discount rates adopted by this Commission. They may then calculate the portion of a retail price that is attributable to avoided costs by multiplying the retail price by the discount rate.

909. We adopt a minimum set of criteria for avoided cost studies used to determine wholesale discount rates. The record before us demonstrates that avoided cost studies can produce widely varying results, depending in large part upon how the proponent of the study interprets the language of section 252(d)(3). The criteria we adopt are designed to ensure that states apply consistent interpretations of the 1996 Act in setting wholesale rates based on avoided cost studies which should facilitate swift entry by national and regional resellers, which may include small entities.[2193] At the same time, our criteria are intended to leave the state commissions broad latitude in selecting costing methodologies that comport with their own ratemaking practices for retail services. Thus, for example, our rules for identifying avoided costs by USOA expense account are cast as rebuttable presumptions, and we do not adopt as presumptively correct any avoided cost model.

910. Based on the comments filed in this proceeding and on our analysis of state decisions setting wholesale discounts, we adopt a default range of rates that will permit a state commission to select a reasonable default wholesale rate between 17 and 25 percent below retail rate levels. A default wholesale discount rate shall be used if: (1) an avoided cost study that satisfies the criteria we set forth below does not exist; (2) a state commission has not completed its review of such an avoided cost study; or (3) a rate established by a state commission before release of this Order is based on a study that does not comply with the criteria described in the following section. A state commission must establish wholesale rates based on avoided cost studies within a reasonable time from when the default rate was selected. This approach will enable state commissions to complete arbitration proceedings within the statutory time frames even if it is infeasible to conduct full-scale avoided cost studies that comply with the criteria

[2192] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[2193] *See Id.*

described below for each incumbent LEC.

a. Criteria for Cost Studies

911. There has been considerable debate on the record in this proceeding and before the state commissions on whether section 252(d)(3) embodies an "avoided" cost standard or an "avoidable" cost standard. We find that "the portion [of the retail rate] . . . attributable to costs that will be avoided" includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business. In other words, the avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers. Thus, we reject the arguments of incumbent LECs and others who maintain that the LEC must actually experience a reduction in its operating expenses for a cost to be considered "avoided" for purposes of section 252(d)(3). We do not believe that Congress intended to allow incumbent LECs to sustain artificially high wholesale prices by declining to reduce their expenditures to the degree that certain costs are readily avoidable. We therefore interpret the 1996 Act as requiring states to make an objective assessment of what costs are reasonably avoidable when a LEC sells its services wholesale. We note that Colorado, Georgia, Illinois, New York, and Ohio commissions have all interpreted the 1996 Act in this manner.[2194]

912. We find that, under this "reasonably avoidable" standard discussed above, an avoided cost study must include indirect, or shared, costs as well as direct costs. We agree with MCI, AT&T, and the California, Illinois, Ohio, Colorado, and Georgia commissions that some indirect or shared costs are avoidable and likely to be avoided when a LEC provides retail services to a reseller instead of to the end user. This is because indirect or shared costs, such as general overheads, support all of the LEC's functions, including marketing, sales, billing and collection, and other avoided retail functions. Therefore, a portion of indirect costs must be considered "attributable to costs that will be avoided" pursuant to section 252(d)(3). It is true that expenses recorded in indirect or shared expense accounts will continue to be incurred for wholesale operations. It is also true, however, that the overall level of indirect expenses can reasonably be

[2194] *See, e.g., U S West Communications, Inc. Filing Advice Letter No. 2610 in Compliance with Commission Decision No. C96-521 Adopting Emergency Rules*, Docket No. 96S-233T (Colorado Commission June 21, 1996) at paras. 12-13; *Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms, and Conditions and Initiate Unbundling of Services*, Docket No. 6352U (Georgia Commission June 21, 1996); *Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company*, Nos. 95-0458 and 95-0531 (consol.) (Illinois Commission June 26, 1996) at 27-34; *Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corporation, WorldCom, Inc. d/b/a LDDS WorldCom and the Empire Association of Long Distance Telephone Companies, Inc. Against New York Telephone Company Concerning Wholesale Provisioning of Local Exchange Service by New York Telephone Company and Sections of New York Telephone's Tariff No. 900*, Case 95-C-0657 (New York Commission July 18, 1996); *Petition of Rochester Telephone Corp. for Approval of a Proposed Restructuring Plan*, Case 93-C-0103 (New York July 18, 1996); *Commission Investigation Relative to the Establishment of Local Exchange Competition and Other Competitive Issues*, Case No. 95-845-TP-COI (Ohio Commission June 12, 1990) at 30-31.

expected to decrease as a result of a lower level of overall operations resulting from a reduction in retail activity.

913. A portion of contribution, profits, or mark-up may also be considered "attributable to costs that will be avoided"[2195] when services are sold wholesale. MCI's model makes this attribution by means of a calculation that applies the same mark-up to wholesale services as to retail services. The Illinois Commission achieved a similar effect by removing a *pro rata* portion of contribution from the retail rate for each service. In AT&T's model, the portion of return on investment (profits) that was attributable to assets used in avoided retail activities was treated as an avoided cost. We find that these approaches are consistent with the 1996 Act.

914. An avoided cost study may not calculate avoided costs based on non-cost factors or policy arguments, nor may it make disallowances for reasons not provided for in section 252(d)(3). The language of section 252(d)(3) makes no provision for selecting a wholesale discount rate on policy grounds. We therefore reject NCTA's argument that discount rates should be ten percent or less in order to avoid discouraging facilities-based competition, as well as AT&T's suggestion that wholesale discount rates should be set at levels that ensure the viability of the reseller's business. We also reject, for example, MCI's assertion that no external relations or research and development costs should be allowed in wholesale rates because the activities represented by those costs are contrary to the interests of the LEC competitors that purchase wholesale services.[2196] Our analysis also precludes a state commission from adopting AT&T's suggestion that an increment should be added to the base discount rate to compensate resellers for alleged deficiencies in the provisioning of services.

915. The 1996 Act requires that wholesale rates be based on existing retail rates, and thus clearly precludes use of a "bottom up" TSLRIC study to establish wholesale rates that are not related to the rates for the underlying retail services. We thus reject the suggestions of those parties that ask us to require use of TSLRIC to set wholesale rates. The 1996 Act does not, however, preclude use of TSLRIC cost studies to identify the portion of a retail rate that is attributable to avoided retail costs. TSLRIC studies would be entirely appropriate in states where the retail rates were established using a TSLRIC method. For example, the Illinois Commission calculated its wholesale rate using an avoided cost formula and long run incremental cost studies. Embedded cost studies, such as the studies used by the Georgia Commission, may also be used to identify avoided costs. Ideally, a state would use a study methodology that is consistent with the manner in which it sets retail rates.

916. We neither prohibit nor require use of a single, uniform discount rate for all of an incumbent LEC's services. We recognize that a uniform rate is simple to apply, and avoids the

[2195] 47 U.S.C. § 252(d)(3).

[2196] *See* MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 6-7.

need to allocate avoided costs among services. Therefore, our default wholesale discount is to be applied uniformly. On the other hand, we also agree with parties who observe that avoided costs may, in fact, vary among services. Accordingly, we allow a state to approve nonuniform wholesale discount rates, as long as those rates are set on the basis of an avoided cost study that includes a demonstration of the percentage of avoided costs that is attributable to each service or group of services.

917. All costs recorded in accounts 6611 (product management), 6612 (sales), 6613 (product advertising) and 6623 (customer services) are presumed to be avoidable. The costs in these accounts are the direct costs of serving customers. All costs recorded in accounts 6621 (call completion services) and 6622 (number services) are also presumed avoidable, because resellers have stated they will either provide these services themselves or contract for them separately from the LEC or from third parties. These presumptions regarding accounts 6611-6613 and 6621-6623 may be rebutted if an incumbent LEC proves to the state commission that specific costs in these accounts will be incurred with respect to services sold at wholesale, or that costs in these accounts are not included in the retail prices of the resold services.

918. General support expenses (accounts 6121-6124), corporate operations expenses (accounts 6711, 6712, 6721-6728), and telecommunications uncollectibles (account 5301) are presumed to be avoided in proportion to the avoided direct expenses identified in the previous paragraph. Expenses recorded in these accounts are tied to the overall level of operations in which an incumbent LEC engages. Because the advent of wholesale operations will reduce the overall level of operations -- for example, staffing should decrease because customer inquiries and billing and collection activity will decrease -- overhead and support expenses are in part avoided. We select the revenue offset account of 5301 rather than accounts 5300 or 6790 because account 5301 most directly represents overheads attributable to the services being resold.

919. Plant-specific and plant non-specific expenses (other than general support expenses) are presumptively not avoidable.

920. In the case of carriers designated as Class B under section 32.11 of our rules that use certain summary accounts in lieu of accounts designated in this subsection of the Order, our avoided cost study criteria shall apply to the relevant summary account in its entirety.[2197]

b. Default Range of Wholesale Discount Rates

921. Parties to this proceeding present evidence or arguments supporting wholesale discount rates ranging from 4.76 percent to 55 percent:

[2197] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

Sprint/United Telephone study	
Simple Access service:	4.76%
Other services:	7.19%
NCTA	10.0%
Comcast	10.0%
Massachusetts Attorney General	25.0%
ACTA	25.0%
MCI Model	25.6-33.2%[2198]
Telecommunications Resellers Ass'n	30.0-50.0%
AT&T Model	23.05%-55.52%[2199]

922. States applying wholesale pricing standards similar to the standards in section 252(d)(3) have set the following wholesale discounts:

California		
PacTel		
	Business	17.0%
	Residential	10.0%
GTE		
	Business	12.0%
	Residential	7.0%
Colorado		
	Residential	9.0%
	Business	16.0%
	Toll Services	30.0%
	Central Office-Based Features	50.0%[2200]
	All other services	18.0%
Georgia		
	Residential	20.3%
	Business	17.3%

[2198] MCI calculated rates based on actual accounting data for the years 1990-1995 for each RBOC and for GTE. For 1995 the rates ranged from 25.6 percent for U S West to 33.2 percent for Ameritech. MCI also calculates rates for 1996 using estimated data. MCI comments at Attachment 2 (Pricing of Wholesale Services), p. 1.

[2199] AT&T calculated separate discount rates for each RBOC study area and for SNET and GTE Hawaiian Tel.

[2200] Central office-based services are custom calling features such as speed dialing and CLASS features, such as caller ID. *U S West Communications, Inc. Filing Advice Letter No. 2610 in Compliance with Commission Decision No. C96-521 Adopting Emergency Rules*, Docket No. 96S-233T (Colorado Commission June 21, 1996) at para. 13.

Illinois	20.07%[2201]
New York	
NYNEX	
Business	17.0%
Residential	11.0%
Rochester Telephone	13.5%

923. We find unpersuasive various arguments presented by parties at the lower and higher ends of the range of possible discounts. The Sprint/United Telephone study produces unreasonably low measures of avoided costs because the study considers only avoided direct expenses in five accounts. As explained above, we interpret the statutory language providing for a wholesale price that excludes the "portion [of a retail rate] attributable to any marketing, billing, collection, and other costs that will be avoided"[2202] to include indirect as well as direct costs. The proposals of NCTA and Comcast for a maximum discount of 10 percent are premised on the view that any greater discount would unduly discourage facilities-based competition. Section 252(d)(3), however, requires wholesale prices to be set based on avoided costs, not on any policy preference for facilities-based competition. For the same statutory reason, we reject as inconsistent with section 252(d)(3) the policy arguments of the Telecommunications Resellers Association and AT&T that we should establish national wholesale discounts at levels that will ensure that resale of local exchange services is a viable business.[2203]

924. We find AT&T's model unsuitable for purposes of establishing in this proceeding a range for default wholesale discount rates. The AT&T model does in many respects satisfy the general criteria we establish above for avoided cost studies. The model, however, incorporates numerous assumptions, cost allocation factors, and studies, and because AT&T submitted its model with its reply comments, and other parties have not analyzed the model in detail. We find that we would need to develop a more complete record on the AT&T model before deciding whether to endorse it. We do not, however, preclude a state commission from considering in a wholesale rate proceeding evidence developed using this model.

925. We find that we can use MCI's model, with some modifications, along with the results of certain state proceedings, to establish a range of rates that would produce an acceptable default wholesale discount rate that reasonably approximates the amount of avoided costs that should be subtracted from the retail rate. A default rate is to be used only in three instances: (1)

[2201] The Illinois Commission requires wholesale discounts to be computed on a service-specific basis. The 20.07 percent figure represents an "average" discount using such a methodology.

[2202] 47 U.S.C. § 252(d)(3).

[2203] *See* AT&T comments at 81-86; Telecommunications Resellers Ass'n comments at 24.

in a state arbitration proceeding if an avoided cost study that satisfies the criteria we set forth above does not exist; (2) where a state has not completed its review of such an avoided cost study; (3) where a rate established by a state before the release date of this Order is based on a study that does not comply with the criteria described in the previous section. We emphasize that the default rate is to be used as an interim measure only, and should be replaced with an avoided cost study within a reasonable time. The MCI model is a reasonable attempt at estimating avoided cost in accordance with section 252(d)(3) using only publicly-available data. We find, however, that we should modify certain features of the model.

926. First, MCI treats account 6722 (external relations) and account 6727 (research and development) as avoidable costs. MCI argues that purchasers of wholesale services are competing with LECs and, therefore, should not be forced to fund regulatory activities reflected in account 6722. MCI claims that research and development are not of practical use for the services that resellers will purchase. As explained above, this type of disallowance is not contemplated by the avoided cost standard of section 252(d)(3). We therefore adjust the model to treat these costs in the same manner as other overhead expense accounts.

927. Second, MCI treats a number of accounts as "other avoided costs" on the grounds that the expenses in those accounts are not relevant to the provision of telecommunications services that an incumbent LEC currently provides.[2204] Public telephone terminal equipment expense and large PBX expense are not "avoided" precisely because they are unrelated to the retail services being discounted. We would not expect these expenses to be included in retail service rates for resold services; but if these expenses were included in retail rates, they would not be avoided when the services are purchased by resellers. The rest of MCI's "other" accounts contain costs that support all of the telecommunications services offered by the company. MCI has not shown that any of these costs are either reduced or eliminated when services are sold at wholesale. We, therefore, adjust the MCI model so as not to treat these accounts as avoidable costs.

928. Third, MCI treats accounts 6611 (product management), 6612 (sales), 6613 (product advertising), and 6623 (customer services) as costs that are entirely avoided with respect to services purchased at wholesale. We agree that a large portion of the expenses in these accounts is avoided when service is sold at wholesale. We also agree, however, with parties that argue that some expenses in these accounts will continue to be incurred with respect to wholesale products and customers, and that some new expenses may be incurred in addressing the needs of resellers as customers. No party in this proceeding has suggested a specific adjustment to the MCI model that would account for these costs of the wholesale operation. We note that, in their

[2204] Based on this rationale, MCI excludes account 6113 (aircraft expense), account 6341 (large PBX expense), account 6511 (property held for future telecommunications use expense), account 6351 (public telephone terminal equipment expense), account 6512 (provisioning expense), account 6562 (depreciation expense for property held for future telecommunications use), and account 6564 (amortization expense, intangible).

own proceedings, several states have made varying estimates concerning the level of wholesale-related expenses in these accounts. Colorado, for example, estimated that none of the costs in accounts 6611-6613 would relate to wholesale services, and that only five percent of the costs in account 6623 would be incurred in a wholesale operation.[2205] The Georgia Commission, on the other hand, decided that 25 percent of sales and product advertising expenses would continue to be incurred in the wholesale operation.[2206] Given the lack of evidence, and the wide range of estimates that have been made by these states, we find it reasonable to assume, for purposes of determining a default range of wholesale discount rates, that ten percent of costs in accounts 6611, 6612, 6613, and 6623 are not avoided by selling services at wholesale.

929. Fourth, MCI uses a complex formula to calculate the portions of overhead and general support expense that are attributable to avoided costs. We find that this formula is constructed in a way that tends to inflate the results of the calculation. We have, therefore, substituted a more straightforward approach in which we apply to each indirect expense category the ratio of avoided direct expense to total expenses. We also identify a slightly different list of accounts representing indirect costs than that proposed by MCI.

930. With the modifications described above, and using actual 1995 data, MCI's model produces the following results for the RBOCs and GTE:

U S West	18.80%
GTE	18.81%
BellSouth	19.20%
Bell Atlantic	19.99%
SBC	20.11%
NYNEX	21.31%
Pacific	23.87%
Ameritech	25.98%

931. We also take into account the experience of those state commissions, Illinois and Georgia, that have undertaken or approved detailed avoided cost studies under the pricing standard of section 252(d)(3) of the 1996 Act. Applying the statutory standard to the examination of significant cost studies, those commissions derived average wholesale discounts of

[2205] *U S West Communications, Inc. Filing Advice Letter No. 2610 in Compliance with Commission Decision No. C96-521 Adopting Emergency Rules*, Docket No. 96S-233T (Colorado Commission June 21, 1996) at para. 12 and n.20. The Colorado Commission explained that it chose 5 percent because "some small portion of customer services will remain for the interfaces of Operational Support Systems of [U S West] and the resellers, but nowhere near the amount necessary for direct customer contact services." *Id.* n.20.

[2206] *Petition of AT&T for the Commission to Establish Resale Rules, Rates, Terms, and Conditions and Initiate Unbundling of Services*, Docket No. 6352U (Georgia Commission June 21, 1996) at Appendix 1. The Georgia Commission characterized its calculations with respect to sales expense as "conservative at best."

18.74 percent[2207] and 20.07 percent. We find that these decisions present evidence of an appropriate wholesale discount that should be given more weight than state commission decisions that have set their discounts under other pricing standards or only on an interim basis.[2208]

932. Accordingly, based on the record before us, we establish a range of default discounts of 17-25 percent that is to be used in the absence of an avoided cost study that meets the criteria set forth above. A state commission that has not set wholesale prices based on avoided cost studies that meet the criteria set forth above as of the release date of this Order shall use a default wholesale discount rate between 17 and 25 percent. A state should articulate the basis for selecting a particular discount rate. If this default discount rate is used, the state commission must establish wholesale rates based on avoided cost studies within a reasonable time. The avoided cost study must comply with the criteria for avoided cost studies described above. A state commission may submit an avoided cost study to this Commission for a determination of whether it complies with these criteria. If a party (either a reseller or an incumbent LEC) believes that a state commission has failed to act within a reasonable period of time, that party may file a petition for declaratory ruling with this Commission, asking us to determine whether the state has failed to comply with this rule. We will, in making such determinations, consider the particular circumstances in the state involved. If a state commission has adopted as of the release date of this Order an interim wholesale pricing decision that relies on an avoided cost study that meets the criteria set forth above, the state commission may continue to require an incumbent LEC to offer services for resale under such interim wholesale prices in lieu of the default discount range, so long as the state commission's interim pricing rules are fully enforceable by resellers and followed by a final decision within a reasonable period of time that adopts an avoided cost study that meets the criteria set forth above.

933. We select the 17 to 25 percent range of default discounts based on our evaluation of the record. The adjusted results of the MCI model taken together with the results of those state proceedings discussed above that indicated they applied the statutory standard produces, a range between 18.74 and 25.98 percent. A majority of these wholesale discount rates fall between 18.74 and 21.11 percent. Other state commissions, such as California and New York, that have

[2207] Prior to apportioning avoided costs between business and residential services, the Georgia Commission's avoided cost computation would have yielded an aggregate wholesale discount rate of 18.74 percent. This figure is computed by dividing the total avoided costs computed by the Georgia Commission by the total BellSouth residential and business revenues (which were used individually both to apportion total avoided costs between residential and business service and as the denominator in the final wholesale discount calculations).

[2208] *See, e.g., Order Instituting Rulemaking on the Commission's Own Motion into Competition for Local Exchange Service*, R. 95-04-043 and I. 95-04-044 (California Commission April 26, 1996); *U S West Communications, Inc. Filing Advice Letter No. 2610 in Compliance with Commission Decision No. C96-521 Adopting Emergency Rules*, Docket No. 96S-233T (Colorado Commission June 21, 1996); *Wholesale Rates for Telecommunications Services Ruling on AT&T's Petition for a Reduction on the Wholesale Rates of Bell Atlantic-Maryland, Inc.*, Case No. 8721 (Maryland Commission June 27, 1996).

employed avoided cost studies have produced wholesale discount rates somewhat below the low end of this range. Furthermore, it has been argued that smaller incumbent LECs' avoided costs are likely to be less than those of the larger incumbent LECs, whose data was used by MCI. Therefore, to allow for these considerations, we select 17 percent as the lower end of the range.[2209] We select 25 percent as the top of the range because it approximates the top of the range of results produced by the modified MCI model. This range gives state commissions flexibility in addressing circumstances of incumbent LECs serving their states and permits resale to proceed until such time as the state commission can review a fully-compliant avoided cost study.

934. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, Bay Springs, *et al.*, argues that national wholesale pricing rules will insufficiently consider operational differences between small and large incumbent LECs.[2210] We take this into consideration in setting the default discount rate and in requiring state commissions to perform carrier-specific avoided cost studies within a reasonable period of time that will reflect carrier-to-carrier differences. We believe, however, that the procompetitive goals of the 1996 Act require us to establish a default discount rate for state commissions to use in the absence of avoided cost studies that comply with the criteria we set forth above. The presumptions we establish in conducting avoided cost studies regarding the avoidability of certain expenses may be rebutted by evidence that certain costs are not avoided, which should minimize any economic impact of our decisions on small incumbent LECs. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.

C. Conditions and Limitations

935. Section 251(c)(4) requires incumbent LECs to make their services available for resale without unreasonable or discriminatory conditions or limitations. This portion of this Order addresses various issues relating to conditions or limitations on resale. It first discusses restrictions, generally, in Section VIII.C.1. Next, it turns to promotional and discounted offerings and the conditions that may attach to such offerings in Section VIII.C.2., and then to refusals to resell residential and below-cost services in Section VIII.C.3. Limitations on the categories of customers to whom a reseller may sell incumbent LEC services are discussed in VIII.C.4. Resale restrictions in the form of withdrawal of service are discussed in VIII.C.5. Finally, Section VIII.C.6. discusses resale restrictions relating to provisioning.

1. Restrictions, Generally, and Burden of Proof

[2209] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[2210] Bay Springs, *et al.*, comments at 17.

a. Background and Comments

936. In the NPRM, we asked whether incumbent LECs should have the burden of proving that restrictions on resale are reasonable and nondiscriminatory.[2211] We stated our belief that, given the pro-competitive goals of the 1996 Act and the view that restrictions and conditions were likely to be evidence of an exercise of market power, the range of permissible restrictions should be quite narrow.[2212]

937. A number of parties, including IXCs, resellers, and some state commissions, agree that incumbent LECs should have the burden of justifying any restrictions they impose on the resale of their services.[2213] For example, Jones Intercable proposes a requirement that incumbent LECs prove that a proposed condition or restriction will directly advance an important public policy objective and that the benefits of the condition plainly outweigh its anticompetitive effects.[2214] Many add the caveat that the only permissible restriction should be the cross-class restriction, section 251(c)(4)(B), prohibiting resellers that obtain at wholesale rates telecommunications services that are available at retail only to a category of subscribers from offering such services to a different category of subscribers.[2215] The Texas Public Utility Counsel suggests that the relevant determination is whether an incumbent LEC could impose the condition in question in a competitive market.[2216]

938. Incumbent LECs support various restrictions and limitations.[2217] BellSouth and the Ohio Consumers' Counsel further suggest that the burden of justifying restrictions and limitations

[2211] NPRM at para. 175.

[2212] *Id.*

[2213] *See, e.g.*, ACSI comments at 60; California Commission comments at 35-37; CFA/CU comments at 17; Citizens Utilities comments at 27; Colorado Commission comments at 52-53; Jones Intercable comments at 24; MFS comments at 70; NEXTLINK comments at 30; Pennsylvania Commission comments at 36; Ohio Commission comments at 62; TCC comments at 43; Telecommunications Resellers Ass'n comments at 20; Washington Commission comments at 32.

[2214] Jones Intercable comments at 32-33.

[2215] *See, e.g.*, CFA/CU comments at 17; Citizens Utilities at 27; Colorado Commission comments at 52-53; TCC comments at 43. Many of these parties offer a narrow interpretation of section 251(c)(4)(B), which will be discussed, *infra*.

[2216] Texas Public Utilities Counsel reply at 42.

[2217] *See, e.g.*, BellSouth comments at 66.

should not be placed on LECs.[2218]

b. Discussion

939. We conclude that resale restrictions are presumptively unreasonable. Incumbent LECs can rebut this presumption, but only if the restrictions are narrowly tailored. Such resale restrictions are not limited to those found in the resale agreement. They include conditions and limitations contained in the incumbent LEC's underlying tariff. As we explained in the NPRM, the ability of incumbent LECs to impose resale restrictions and conditions is likely to be evidence of market power and may reflect an attempt by incumbent LECs to preserve their market position. In a competitive market, an individual seller (an incumbent LEC) would not be able to impose significant restrictions and conditions on buyers because such buyers turn to other sellers. Recognizing that incumbent LECs possess market power, Congress prohibited unreasonable restrictions and conditions on resale. We, as well as state commissions, are unable to predict every potential restriction or limitation an incumbent LEC may seek to impose on a reseller. Given the probability that restrictions and conditions may have anticompetitive results, we conclude that it is consistent with the procompetitive goals of the 1996 Act to presume resale restrictions and conditions to be unreasonable and therefore in violation of section 251(c)(4). This presumption should reduce unnecessary burdens on resellers seeking to enter local exchange markets, which may include small entities, by reducing the time and expense of proving affirmatively that such restrictions are unreasonable.[2219] We discuss several specific restrictions below including certain restrictions for which we conclude the presumption of unreasonableness shall not apply. We also discuss certain restrictions that we will presume are reasonable.

2. Promotions and Discounts

a. Background and Comments

940. In the NPRM, we asked whether an incumbent LEC's obligation to make their services available for resale at wholesale rates applies to discounted and promotional offerings and, if so, how.[2220] We also asked, if the wholesale pricing obligation applies to promotions and discounts, whether the reseller entrant's customer must take service pursuant to the same restrictions that apply to the incumbent LEC's retail customers.[2221]

[2218] BellSouth comments at 65; Ohio Consumers' Counsel comments at 35.

[2219] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

[2220] NPRM at para. 175.

[2221] *Id.*

941. Incumbent LECs and Time Warner argue that they should not be required to offer discounted and promotional offerings at wholesale rates.[2222] These parties argue that promotions and discounts are merely subsets of standard offerings, or that promotions and discounts are only devices for marketing underlying "telecommunications services."[2223] Thus, these parties argue, a discounted and promotional offering is not in itself a "telecommunications service" that is subject to the resale requirement as long as the standard offering is made available for resale at wholesale rates.[2224]

942. Incumbent LECs argue that requiring promotions and discounts to be made available at wholesale rates will discourage such offerings. According to incumbent LECs, promotions and discounts serve as a means by which incumbent LECs differentiate their services from resellers' offerings.[2225] Furthermore, they contend that establishing a system where resellers' service and pricing options track incumbent LECs' promotions and discounts would promote collusion rather than competition.[2226] SBC notes that resellers will have access to volume discounts (through aggregating) that will allow them to compete with promotions and discounts offered by incumbent LECs.[2227] Incumbent LECs argue that many promotions, such as offering installation at no charge for new customers for limited periods, are short-term and used as marketing tools.[2228] Some parties suggest that the wholesale rate obligation should, at least, not attach to offerings that are only available for a limited period of time.[2229] Specifically, some parties recommend that we not permit incumbent LECs not to offer wholesale rates for offerings that are only available for 120 days or less.[2230]

[2222] *See, e.g.*, Ameritech comments at 57; Bell Atlantic comments at 46; MECA comments at 60; NYNEX comments at 76; SNET comments at 34; Time Warner comments at 73; U S West comments at 67; USTA comments at 72. Some parties commented only with respect to promotional offerings. *See, e.g.*, BellSouth comments at 66; Cincinnati Bell comments at 34; PacTel comments at 87; SBC comments at 72.

[2223] *See, e.g.*, Ameritech comments at 57; NYNEX comments at 76.

[2224] *See, e.g.*, Bell Atlantic reply at 23-24; GTE comments at 50; MECA comments at 60; NYNEX comments at 76; Time Warner comments at 73.

[2225] *See, e.g.*, BellSouth comments at Attachment (Interconnection and Economic Efficiency), p. 22; Cincinnati Bell comments at 33; USTA comments at Attachment (Affidavit of Jerry Hausman), p.14.

[2226] GTE comments at 50.

[2227] SBC comments at 72-73.

[2228] *See, e.g.*, NYNEX comments at 76 (promotions are merely short term waivers of nonrecurring charges).

[2229] Ameritech comments at 56-57; GTE reply at 27 n.49; Ohio Consumer's Counsel comments at 36; PacTel reply at 45.

[2230] *See, e.g.*, Ameritech comments at 57.

943. Some parties also contend that section 251(c)(4) resale obligations should not apply to contract,[2231] trial,[2232] or community service offerings.[2233] GTE and U S West argue that high volume rate offerings should not be subject to the wholesale rate obligation because they are already discounted.[2234] Ameritech and Bell Atlantic argue that contract offerings are not subject to resale because they are not made generally available.[2235]

944. IXCs, resellers, and DoJ argue that if incumbent LECs are not required to offer promotions and other discounts at wholesale rates, incumbent LECs will be able to undercut rates that resellers offer.[2236] They contend that services, classes of customers, or even individual customers could be strategically targeted by the incumbent LECs.[2237] The Telecommunications Resellers Association and others argue that price reductions that are designed to drive competitors from the market do not produce long-term gains for consumers.[2238] The Ohio Consumers' Counsel argues that, if the Commission were to exempt short-term promotional offerings, 120 days is too long to be considered short-term.[2239] IXCs and resellers contend that contract offerings should be made available for resale.[2240]

945. Incumbent LECs, some state commissions, and the Ohio Consumers' Counsel argue that if promotions and discounts are subject to wholesale pricing, reseller end-users must take

[2231] BellSouth comments at 66; USTA comments at 72.

[2232] Bell Atlantic reply at 23-24; SBC comments at 71; USTA comments at 72.

[2233] J. Staurulakis comments at 7. LDDS advocates that resale of community service offerings be limited to the class of subscribers eligible to receive such offerings. LDDS comments at 84.

[2234] GTE comments at 49-50; U S West comments at 68.

[2235] Ameritech reply at 47; Bell Atlantic reply at 24.

[2236] *See, e.g.*, AT&T comments at 83; Cable & Wireless comments at 37; Telecommunications Resellers Ass'n reply at 13; DoJ comments at 54-55. For this reason, the Washington Commission made its support of promotional and discount resale restrictions contingent on rules that would prevent incumbent LECs from pricing such offerings below rates offered to resellers. Washington Commission comments at 32.

[2237] *See, e.g.*, Telecommunications Resellers Ass'n reply at 13.

[2238] Telecommunications Resellers Ass'n reply at 13.

[2239] Ohio Consumers' Counsel reply at 30.

[2240] *See, e.g.*, LDDS reply at 43; Telecommunications Resellers Ass'n reply at 14.

such promotions and discounts under the same conditions as incumbent LEC end users.[2241] Resellers argue, however, that incumbent LECs will use this latitude to engage in anticompetitive practices by creating conditions that will have an unnecessarily greater impact on typical reseller end users than incumbent LEC end users.[2242]

946. Incumbent LECs also seek to limit reseller end user eligibility to purchase resold incumbent LEC high-volume offerings to those eligible to receive such offerings directly from the incumbent LEC.[2243] Such a limitation would prevent high-volume services from being resold to low-volume customers. MFS argues that such restrictions should be considered per se unreasonable because this is a significant source of the resellers' competitive advantage.[2244] The Ohio and Pennsylvania Commissions also support resellers' rights to aggregate low volume customers to take advantage of the resulting buying power.[2245]

947. U S West generally argues that resellers should make the same type of purchasing commitments made by current purchasers of wholesale services.[2246] Often, U S West argues, wholesalers are required to concentrate their purchases on services from a limited number of switches in order to receive volume discounts. U S West argues that incumbent LECs should be allowed to require the same types of commitments from resellers purchasing such services.[2247] U S West and GTE propose allowing incumbent LECs to impose term requirements on resold offerings.[2248] Cable & Wireless opposes both of these requirements and suggests that they be made presumptively unreasonable.[2249]

[2241] *See, e.g.*, SBC reply at 15 n.34, PacTel comments at 45 n.95; Alabama Commission comments at 26; Ohio Consumers' Counsel comments at 35-36.

[2242] *See, e.g.*, Cable & Wireless comments at 42; Telecommunications Resellers Ass'n comments at 19 n.50.

[2243] *See, e.g.*, GTE comments at 49-50; California Commission comments at 35-37; PacTel reply at 45 n.95.

[2244] MFS comments at 70.

[2245] Ohio Commission comments at 65; Pennsylvania Commission comments at 36. The Ohio Commission, however, specifically states that it is opposed to federal rules on this subject. Ohio Commission at 65.

[2246] U S West comments at 67.

[2247] *Id.*

[2248] U S West comments at 67; GTE comments at 47.

[2249] Cable & Wireless comments at 48-49.

b. Discussion

948. Section 251(c)(4) provides that incumbent LECs must offer for resale at wholesale rates "any telecommunications service" that the carrier provides at retail to noncarrier subscribers. This language makes no exception for promotional or discounted offerings, including contract and other customer-specific offerings. We therefore conclude that no basis exists for creating a general exemption from the wholesale requirement for all promotional or discount service offerings made by incumbent LECs. A contrary result would permit incumbent LECs to avoid the statutory resale obligation by shifting their customers to nonstandard offerings, thereby eviscerating the resale provisions of the 1996 Act. In discussing promotions here, we are only referring to price discounts from standard offerings that will remain available for resale at wholesale rates, *i.e.*, temporary price discounts.[2250]

949. There remains, however, the question of whether all short-term promotional prices are "retail rates" for purposes of calculating wholesale rates pursuant to section 252(d)(3). The 1996 Act does not define "retail rate;" nor is there any indication that Congress considered the issue. In view of this ambiguity, we conclude that "retail rate" should be interpreted in light of the pro-competitive policies underlying the 1996 Act. We recognize that promotions that are limited in length may serve procompetitive ends through enhancing marketing and sales-based competition and we do not wish to unnecessarily restrict such offerings. We believe that, if promotions are of limited duration, their procompetitive effects will outweigh any potential anticompetitive effects. We therefore conclude that short-term promotional prices do not constitute retail rates for the underlying services and are thus not subject to the wholesale rate obligation.

950. We must also determine when a promotional price ceases to be "short term" and must therefore be treated as a retail rate for an underlying service. Incumbent LEC commenters support 120 days as the maximum period for such promotions. This has been criticized as being too long. We are concerned that excluding promotions that are offered for as long as four months may unreasonably hamper the efforts of new competitors that seek to enter local markets through resale. We believe that promotions of up to 90 days, when subjected to the conditions outlined below, will have significantly lower anticompetitive potential, especially as compared to the potential procompetitive marketing uses of such promotions. We therefore establish a presumption that promotional prices offered for a period of 90 days or less need not be offered at a discount to resellers. Promotional offerings greater than 90 days in duration must be offered for resale at wholesale rates pursuant to section 251(c)(4)(A). To preclude the potential for abuse of promotional discounts, any benefit of the promotion must be realized within the time period of the promotion, *e.g.*, no benefit can be realized more than ninety days after the promotional offering is taken by the customer if the promotional offering was for ninety days. In addition, an incumbent LEC may not use promotional offerings to evade the wholesale obligation, for example

[2250] Limited time offerings of service are still subject to resale pursuant to *supra* Section VIII.A.

by consecutively offering a series of 90-day promotions.

951. We find unconvincing the arguments that the offerings under section 251(c)(4) should not apply to volume-based discounts. The 1996 Act on its face does not exclude such offerings from the wholesale obligation. If a service is sold to end users, it is a retail service, even if it is priced as a volume-based discount off the price of another retail service. The avoidable costs for a service with volume-based discounts, however, may be different than without volume contracts.

952. We are concerned that conditions that attach to promotions and discounts could be used to avoid the resale obligation to the detriment of competition. Allowing certain incumbent LEC end user restrictions to be made automatically binding on reseller end users could further exacerbate the potential anticompetitive effects. We recognize, however, that there may be reasonable restrictions on promotions and discounts. We conclude that the substance and specificity of rules concerning which discount and promotion restrictions may be applied to resellers in marketing their services to end users is a decision best left to state commissions, which are more familiar with the particular business practices of their incumbent LECs and local market conditions. These rules are to be developed, as necessary, for use in the arbitration process under section 252.

953. With respect to volume discount offerings, however, we conclude that it is presumptively unreasonable for incumbent LECs to require individual reseller end users to comply with incumbent LEC high-volume discount minimum usage requirements, so long as the reseller, in aggregate, under the relevant tariff, meets the minimal level of demand. The Commission traditionally has not permitted such restrictions on the resale of volume discount offers.[2251] We believe restrictions on resale of volume discounts will frequently produce anticompetitive results without sufficient justification. We, therefore, conclude that such restrictions should be considered presumptively unreasonable. We note, however, that in calculating the proper wholesale rate, incumbent LECs may prove that their avoided costs differ when selling in large volumes.

3. Below-Cost and Residential Service

a. Background and Comments

954. Responding to our general questions regarding the scope of limitations that may be

[2251] *See, e.g., Regulatory Policies Concerning Resale and Shared Use of Common Carrier Services and Facilities*, Docket No. 20097, Report and Order, 60 FCC 2d 261, 308-16 (1976) (divisions of full time private line circuits will enable smaller users to make efficient, discrete use of private line offerings, and such advantages will be in terms of cost savings and selectivity rather than technical advantages).

placed on competitors' resale of incumbent LEC services,[2252] parties addressed in their comments whether below-cost and residential services are subject to section 251(c)(4). Generally, those arguing against application of the wholesale discount also argue against requiring or even allowing resale of below-cost services. Incumbent LECs, including small incumbent LECs serving higher cost areas, and some state commissions argue that restrictions on resale of below-cost services are permissible.[2253] They argue that these services are often funded through internal subsidies that diminish with the onset of competition.[2254] GTE argues that there simply are no costs to avoid where below-cost services are offered at wholesale.[2255] GTE and PacTel argue that, if we were to apply wholesale pricing to services offered below cost, we should delay doing so until states have had the opportunity to rebalance rates.[2256]

955. Potential competitors, primarily IXCs, argue that incumbent LEC losses will not be increased as a result of resale of these services, even at a discount, so long as the services are only sold to the same class of customers to whom the incumbent LEC's offering is available.[2257] Jones Intercable further argues that not allowing resellers to "serve" customers currently subscribing to below-cost service violates the universal service provisions of the 1996 Act.[2258] The Telecommunications Resellers Association notes that establishing rules based on whether a service is offered below, at, or above cost will invite lengthy regulatory disputes.[2259] Additionally, TCC points out that incumbent LECs will continue to receive access revenue even from resold service and such revenue will continue to subsidize such services.[2260]

[2252] NPRM at para. 175.

[2253] *See, e.g.*, MECA comments at 60; SBC comments at 71-72; SNET comments at 31-32; U S West comments at 67; GTE comments at 46 (acknowledging, however, that its position on this might change depending on the outcome of universal service reform); Oregon Commission comments at 31. Additionally, incumbent LECs argue that steps should be taken to ensure that the underlying provider of the service continues to receive universal service payments. *See, e.g.*, NYNEX comments at 84.

[2254] SNET comments at 31-32. Bell Atlantic argues that this might even be considered an unconstitutional taking. Bell Atlantic reply at Attachment 2 (Epstein Declaration), p. 7.

[2255] GTE comments at 46.

[2256] PacTel reply at 44; GTE reply at 26-27.

[2257] *See, e.g.*, AT&T comments at 80; California Commission reply at 21-22; Competition Policy Institute comments at 24; GCI comments at 1, 14; LDDS comments at 84; MCI comments at 89; Sprint reply at 35-37; TCC comments at 44 n.44; Telecommunications Resellers Ass'n reply at 15.

[2258] Jones Intercable comments at 32-33.

[2259] Telecommunications Resellers Ass'n reply at 15.

[2260] TCC comments at 44 n.44.

b. Discussion

956. Subject to the cross-class restrictions discussed below, we believe that below-cost services are subject to the wholesale rate obligation under section 251(c)(4). First, the 1996 Act applies to "any telecommunications service" and thus, by its terms, does not exclude these types of services. Given the goal of the 1996 Act to encourage competition, we decline to limit the resale obligation with respect to certain services where the 1996 Act does not specifically do so. Second, simply because a service may be priced at below-cost levels does not justify denying customers of such a service the benefits of resale competition. We note that, unlike the pricing standard for unbundled elements, the resale pricing standard is not based on cost plus a reasonable profit. The resale pricing standard gives the end user the benefit of an implicit subsidy in the case of below-cost service, whether the end user is served by the incumbent or by a reseller, just as it continues to take the contribution if the service is priced above cost. So long as resale of the service is generally restricted to those customers eligible to receive such service from the incumbent LEC, as discussed below, demand is unlikely to be significantly increased by resale competition. Thus, differences in incumbent LEC revenue resulting from the resale of below-cost services should be accompanied by proportionate decreases in expenditures that are avoided because the service is being offered at wholesale.

957. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, MECA argues that services incumbent LECs offer at below cost rates should not be subject to resale under section 251(c)(4). We do not adopt MECA's proposal. As explained above, we conclude that the 1996 Act provides that below-cost services are subject to the section 251(c)(4) resale obligation and that differences in incumbent LEC revenue resulting from the resale of below-cost services should be accompanied by decreases in expenditures that are avoided because the service is being offered at wholesale. Therefore, resale of below-cost services at wholesale rates should not adversely impact small incumbent LECs.[2261] We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.

4. Cross-Class Selling

a. Background

958. In the NPRM, we sought comment on the meaning of section 251(c)(4)(B) which provides that "[a] State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from

[2261] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

offering such service to a different category of subscribers."[2262] We suggested that competing telecommunications carriers should not be allowed to purchase a subsidized service that is offered to a specific category of subscribers and then resell such service to other customers. We tentatively concluded, for example, that it might be reasonable for a state to restrict the resale of a residential exchange service that is limited to low-income consumers, such as the existing Lifeline program.[2263] We noted that we have generally not allowed carriers to prevent other carriers from purchasing high-volume, low-price offerings to resell to a broad pool of lower volume customers.[2264] Similarly, we inquired into the propriety of practices such as limiting the resale of flat-rated service.[2265]

b. Comments

959. There is a general consensus among incumbent LECs, IXCs, and others that resale of residential service should be limited to customers eligible to take such service from the incumbent LEC under section 251(c)(4)(B).[2266] There is a similar consensus that resale of Lifeline service should be limited to those eligible to receive such service from the incumbent LEC.[2267] Some argue that section 251(c)(4)(B) is only applicable to classes of subscribers whose service is explicitly subsidized or provided at below-cost rates and that broader cross-class restrictions should be considered unreasonable.[2268] Ohio Consumers' Counsel argues that residential services that may be offered above cost are still offered at a lower profit margin than business services for public policy reasons, justifying the inclusion of all residential services in

[2262] NPRM at para. 176.

[2263] *Id.*

[2264] *Id.*

[2265] This practice of limiting the resale of flat-rated services was listed as an example of state practices on which we sought comment in the NPRM at para. 177.

[2266] *See, e.g.*, ACTA comments at 25; Ameritech comments at 54; California Commission comments at 35-37; CFA/CU comments at 16; Comptel reply at 43 n.114; GTE comments at 49-50; GVNW comments at 39; Illinois Ind. Tel. Ass'n comments at 6; MCI comments at 89; NCTA comments at 57; PacTel comments at 87; Sprint comments at 70. Texas Public Utility Counsel argues that the residential cross class selling restrictions should merely prohibit the resale of flat-rated residential service to business customers. Texas Public Utility Counsel comments at 44-45.

[2267] *See, e.g.*, California Commission comments at 36-37; LDDS comments at 84; NYNEX comments at 80.

[2268] *See, e.g.*, AT&T reply at 38-39; DOJ comments at 54; Telecommunications Resellers Association comments at 17 n.46.

the scope of section 251(c)(4)(B).[2269]

960. NYNEX and the Massachusetts Commission argue that incumbent LECs may prohibit the resale of flat-rated services.[2270] They argue that resale of services to multiple-use customers would be unfair to incumbent LECs. National Private Telecommunications Association and Jones Intercable advocate that incumbent LECs should not be allowed to impose resale restrictions that would prevent the offering of shared tenant services operations. Shared tenant services operations involve using trunking to serve multiple unit dwellings with fewer lines than would be needed if each unit separately subscribed to service directly from the incumbent LEC.[2271]

961. Finally, some parties express concern that incumbent LECs will create multitudes of classes in order to prevent resellers, as a practical matter, from competing to provide such services and recommend that any new classes be presumed unreasonable.[2272]

c. Discussion

962. There is general agreement that residential services should not be resold to nonresidential end users, and we conclude that restrictions prohibiting such cross-class reselling of residential services are reasonable. We conclude that section 251(c)(4)(B) permits states to prohibit resellers from selling residential services to customers ineligible to subscribe to such services from the incumbent LEC. For example, this would prevent resellers from reselling wholesale-priced residential service to business customers. We also conclude that section 251(c)(4)(B) allows states to make similar prohibitions on the resale of Lifeline or any other means-tested service offering to end users not eligible to subscribe to such service offerings. State commissions have established rate structures that take into account certain desired balances between residential and business rates and the goal of maximizing access by low-income consumers to telecommunications services. We do not wish to disturb these efforts by prohibiting or overly narrowing state commissions' ability to impose such restrictions on resale.

963. Shared tenant services are made possible through the resale and trunking of flat-rated services to multiple customers. We do not believe that these or other efficient uses of technology should be discouraged through restrictions on the resale of flat-rated offerings to multiple end users, even if incumbent LECs have not always priced such offerings assuming these

[2269] Ohio Consumers' Counsel comments at 36.

[2270] NYNEX comments at 80; Mass. Commission comments at 5; MECA comments at 61.

[2271] National Private Telecommunications Ass'n reply at 4-5; Jones Intercable reply at 27.

[2272] CompTel comments at 102.

usage patterns. We therefore conclude that such restrictions are presumptively unreasonable.

964. We also conclude that all other cross-class selling restrictions should be presumed unreasonable. Without clear statutory direction concerning potentially allowable cross-class restrictions, we are not inclined to allow the imposition of restrictions that could fetter the emergence of competition. As with volume discount and flat-rated offerings, we will allow incumbent LECs to rebut this presumption by proving to the state commission that the class restriction is reasonable and nondiscriminatory.

5. Incumbent LEC Withdrawal of Services

a. Background

965. In the NPRM, we sought comment on whether an incumbent LEC can avoid making a service available at wholesale rates by ceasing to offer the retail service on a retail basis, or whether the incumbent should first be required to make a showing that withdrawing the offering is in the public interest or that competitors will continue to have an alternative way of providing service. We also asked if access to unbundled elements addresses the concern that incumbent LECs could withdraw retail services.[2273]

b. Comments

966. A number of large incumbent LECs and USTA argue that incumbent LECs should be allowed to withdraw services unilaterally and unconditionally.[2274] These parties argue that they have the right to make their own business decisions and the right to terminate the offering of a service that they feel is unprofitable.[2275] Some potential competitors also supported the ability of incumbent LECs to withdraw service, but explicitly conditioned such support on bilateral "grandfathering" of existing customers, *i.e.*, allowing current end users of the terminated service to continue to purchase the service at least for a limited time.[2276] These services then would not be required to be offered for resale because they are no longer offered to the public.[2277] Thus, these parties argue that there would be a permissible restriction on the resale of "grandfathered" services permitting resale only to "grandfathered" customers. Some incumbent LECs suggest that potential concerns over incumbent LEC withdrawal of service would be eliminated if both

[2273] NPRM at para. 175.

[2274] *See, e.g.*, Ameritech comments at 54-55; GTE comments at 48; SBC comments at 73.

[2275] *See, e.g.*, Ameritech reply at 48; GTE comments at 48-49; MECA comments at 60-61.

[2276] *See, e.g.*, Cable & Wireless comments at 42-43.

[2277] *See, e.g.*, SBC comments at 73; J. Staurulakis comments at 5-6.

resellers and incumbent LECs could compete for grandfathered customers.[2278]

967. Several commenters, primarily IXCs, resellers, and state commissions, expressed concern about the incumbent LECs' ability to circumvent resale obligations by withdrawing services that resellers are able to use to compete effectively.[2279] IXCs, resellers, some state commissions, and others argue that unilateral withdrawals of service should be considered presumptively unreasonable.[2280] Several commenters discuss U S West's attempted withdrawal of Centrex service, a small business service that resellers frequently wish to purchase to compete with incumbent LECs, as an example of such behavior.[2281] Others ask us to require that there be a substitutable alternative to a withdrawn service before it could be withdrawn.[2282] The Telecommunications Resellers Association and Cable & Wireless argue that even the existence of a competitive alternative is not sufficient to prevent anticompetitive behavior because such a standard represents an open invitation to strategic manipulation of service offerings and pricing.[2283] Both the Ohio Commission and the Competition Policy Institute argue that access to unbundled elements does not alleviate concerns about incumbent LEC withdrawal of service offerings.[2284]

c. Discussion

968. We are concerned that the incumbent LECs' ability to withdraw services may have anticompetitive effects where resellers are purchasing such services for resale in competition with the incumbent. We decline to issue general rules on this subject because we conclude that this is a matter best left to state commissions. Many state commissions have rules regarding the

[2278] Ameritech reply at 49; NYNEX reply at 37.

[2279] *See, e.g.*, ACTA comments at 9; AT&T reply 37-38; CompTel comments at 101; DOJ comments at 55; Florida Commission comments at 36; MCI comments at 85; Sprint reply at 35-37; Telecommunications Resellers Ass'n comments 18-19.

[2280] *See, e.g.*, AT&T reply at 37-38; Cable & Wireless comments at 43; Ohio Commission comments at 63-64; Pennsylvania Commission comments at 36; Washington Commission comments at 32-33; ASCI comments at 59-60; Competition Policy Institute comments at 25.

[2281] *See, e.g.*, ACTA comments at 9; MCI comments at 87-88; TCC comments at 44.

[2282] Competition Policy Institute comments at 25; GST comments at 32; MFS comments at 71-72; Ohio Commission comments at 65. MCI and Frontier propose that a showing that there is no demand for a service would also be sufficient. MCI comments at 88; Frontier comments at 28. DoJ argues that unilateral withdrawal should only be allowed if the service is shown to be obsolete. DoJ comments at 55-56.

[2283] Telecommunications Resellers Ass'n comments at 19 n.49; Cable & Wireless comments at 43.

[2284] Ohio Commission comments at 64; Competition Policy Institute comments at 26.

withdrawal of retail services and have experience regulating such matters. States can assess, for example, the universal service implications of an incumbent LEC's proposal to withdraw a retail service. Therefore, we conclude that our general presumption that incumbent LEC restrictions on resale are unreasonable does not apply to incumbent LEC withdrawal of service. States must ensure that procedural mechanisms exist for processing complaints regarding incumbent LEC withdrawals of services. We find it important, however, to ensure that grandfathered customers -- subscribers to the service being withdrawn who are allowed by an incumbent LEC to continue purchasing services -- not be denied the benefits of competition. We conclude that, when an incumbent LEC grandfathers its own customers of a withdrawn service, such grandfathering should also extend to reseller end users. For the duration of any grandfathering period, all grandfathered customers should have the right to purchase such grandfathered services either directly from the incumbent LEC or indirectly through a reseller.[2285] The incumbent LEC shall offer wholesale rates for such grandfathered services to resellers for the purpose of serving grandfathered customers.

6. Provisioning

a. Comments

969. Resellers and IXCs express concern that incumbent LECs are not making, and will not make, services available for resale in a timely manner or fail to provide a minimal level of operational support and service quality.[2286] Such resellers and IXCs also argue that incumbent LEC claims of capacity shortages should not excuse failures to provide timely service or to treat resellers on an equal basis with other incumbent LEC customers.[2287] Cable & Wireless argues that customer changeover charges should not be allowed to exceed the same Primary Interexchange Carrier ("PIC") charge that is imposed when customers switch from one IXC to another.[2288] TCC proposes a set of rules regarding nondiscriminatory treatment of resellers and reporting requirements to implement such rules.[2289] These rules include provision of unbranded or rebranded operator and directory assistance services, a proposal also supported by AT&T, TCC, and ACSI.[2290] Incumbent LECs argue that refusing to build out their networks to handle reseller

[2285] *See Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company*, Nos. 95-0458 and 95-0531 (consol.) (Illinois Commission June 26, 1996) at 38.

[2286] *See, e.g.*, Telecommunications Resellers Ass'n comments at 20-23; MCI comments at 88-89.

[2287] *See, e.g.*, Telecommunications Resellers Ass'n reply at 16 n.34; LDDS reply at 43.

[2288] Cable & Wireless comments at 49-50.

[2289] *See* TCC reply at 29-33.

[2290] *See* AT&T comments at 81 n.123; TCC reply at 31; ACSI comments at 47-48.

requests when they lack capacity is a reasonable course of action to prevent stranded investment should the reseller eventually build facilities of its own.[2291]

b. Discussion

970. We conclude that service made available for resale be at least equal in quality to that provided by the incumbent LEC to itself or to any subsidiary, affiliate, or any other party to which the carrier directly provides the service, such as end users. Practices to the contrary violate the 1996 Act's prohibition of discriminatory restrictions, limitations, or prohibitions on resale. This requirement includes differences imperceptible to end users because such differences may still provide incumbent LECs with advantages in the marketplace. Additionally, we conclude that incumbent LEC services are to be provisioned for resale with the same timeliness as they are provisioned to that incumbent LEC's subsidiaries, affiliates, or other parties to whom the carrier directly provides the service, such as end users. This equivalent timeliness requirement also applies to incumbent LEC claims of capacity limitations and incumbent LEC requirements relating to such limitations, such as potential down payments. We note that common carrier obligations, established by federal and state law and our rules, continue to apply to incumbent LECs in their relations with resellers. With regard to customer changeover charges, we conclude that states should determine reasonable and nondiscriminatory rates for such charges.

971. Brand identification is likely to play a major role in markets where resellers compete with incumbent LECs for the provision of local and toll service. This brand identification is critical to reseller attempts to compete with incumbent LECs and will minimize consumer confusion. Incumbent LECs are advantaged when reseller end users are advised that the service is being provided by the reseller's primary competitor. We therefore conclude that where operator, call completion, or directory assistance service is part of the service or service package an incumbent LEC offers for resale, failure by an incumbent LEC to comply with reseller branding requests presumptively constitutes an unreasonable restriction on resale. This presumption may be rebutted by an incumbent LEC proving to the state commission that it lacks the capability to comply with unbranding or rebranding requests. We recognize that an incumbent LEC may incur costs in complying with a request for unbranding or rebranding. Because we do not have a record on which to determine the level of fees or wholesale pricing offsets that may reasonably be assessed to recover these costs, we leave such determinations to the state commissions.

D. Resale Obligations of LECs Under Section 251(b)(1)

972. Section 251(b)(1) imposes a duty on all LECs to offer certain services for resale.

[2291] *See, e.g.*, U S West comments, Exhibit A (Federal Implementation of the Telecommunications Act of 1996) at 25-26. Incumbent LECs argue that they should be able to require minimum volume and term discounts if they must build out facilities. *See* Ameritech at 54; MECA comments at 60.

Specifically, section 251(b)(1) requires LECs "not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services."[2292]

1. Background

973. In the NPRM, we sought comment generally on the relationship of section 251(b)(1) to section 251(c)(4).[2293] We sought comment on whether all LECs are prohibited from imposing unreasonable restrictions on resale of their services, but only incumbent LECs that provide retail services to subscribers that are not telecommunications carriers are required to make such services available at wholesale rates to requesting telecommunications carriers.[2294] We also sought comment on what types of resale restrictions should be permitted under section 251(b)(1) and stated our belief that few, if any, conditions or limitations should be permitted for the same reasons that resale restrictions are sharply limited under section 251(c)(4).[2295] We also asked what standards should be adopted for determining whether resale restrictions should be permitted, and whether presumptions should be established.[2296]

2. Comments

974. A variety of commenters, including Cable & Wireless, Teleport, and several state commissions, support the view that wholesale pricing does not apply to nonincumbent LECs.[2297] A similar group of parties argue that the prohibition on unreasonable or discriminatory resale restrictions applies to nonincumbent LECs.[2298] The Ohio Consumers' Counsel contends that although nothing in section 251 requires states to create wholesale pricing for section 251(b)(1) resale, nothing in the 1996 Act prevents imposition of such pricing.[2299]

975. The Telecommunications Resellers Association argues that all resale restrictions by

[2292] 47 U.S.C. § 251(c)(4).

[2293] NPRM at para. 173.

[2294] *Id.* at para. 174.

[2295] *Id.*

[2296] *Id.* at para. 197.

[2297] *See, e.g.*, Cable & Wireless comments at 38 n.68; Teleport comments at 55; Pennsylvania Commission comments at 35.

[2298] Ohio Commission comments at 60-61; Pennsylvania Commission comments at 35; Teleport comments at 55; Cincinnati Bell comments at 31.

[2299] Ohio Consumers' Counsel comments at 35.

all LECs should be presumed unreasonable.[2300] MFS and Citizens Utilities contend that resale restrictions in sections 251(b)(1) and 251(c)(4)(B) should be interpreted in the same way.[2301] MFS and GST both argue that any restriction of a type that has been found reasonable for incumbent LECs should be presumed reasonable for all other LECs.[2302] NCTA asserts that new competitors have a great incentive to minimize costs, which will often involve using resellers for distribution purposes.[2303] They argue that to ensure that the resale obligations of entrants do not adversely impact their ability to engage in facilities-based competition with incumbent LECs, the Commission should defer the duty of facilities-based competitors to engage in resale.[2304]

3. Discussion

976. There are two differences between the resale obligations in section 251(b)(1) and in section 251(c)(4): the scope of services that must be resold and the pricing of such resale offerings. Section 251(b)(1) requires resale of all telecommunications services offered by the carrier while section 251(c)(4) only applies to telecommunications services that the carrier provides at retail to subscribers who are not telecommunications carriers. Thus, the scope of services to which section 251(b)(1) applies is larger and necessarily includes all services subject to resale under section 251(c)(4). We need not prescribe a minimum list of services that are subject to the 251(b)(1) resale requirement for the same reasons that we specified for not prescribing such a list in Section VIII.A. of this Order. We note that section 251(b)(1) clearly omits a wholesale pricing requirement. We therefore conclude that the 1996 Act does not impose wholesale pricing requirements on nonincumbent LECs. Nonincumbent LECs definitionally lack the market power possessed by incumbent LECs[2305] and were therefore not made subject to the wholesale pricing obligation in the 1996 Act. Their wholesale rates will face competition by incumbent LECs, making a wholesale pricing requirement for nonincumbent LECs unnecessary.

977. Sections 251(b)(1) and 251(c)(4) contain the same statutory standards regarding resale restrictions. Therefore, we conclude that our rules concerning resale restrictions under section 251(b)(1), such as the general presumption that all resale restrictions are unreasonable, should be the same as under section 251(c)(4). We conclude that any restriction of a type that has been found reasonable for incumbent LECs should be deemed reasonable for all other LECs

[2300] Telecommunications Resellers Ass'n comments at 53.

[2301] MFS comments at 69; Citizens Utilities comments at 27.

[2302] MFS comments at 75-76; GST comments at 33.

[2303] NCTA comments at 20-21.

[2304] *Id.* at 21.

[2305] *See* 47 U.S.C. § 251(h)(2).

as well.

E. Application of Access Charges

1. Background

978. In the NPRM, we suggested that an entrant that merely resold a bundled retail service purchased at wholesale rates would not receive access revenues.[2306] In other words, IXCs must still pay access charges to incumbent LECs for originating and terminating interstate traffic of an end user served by a telecommunications carrier that resells incumbent LEC services under section 251(c)(4).

2. Comments

979. Parties that commented on this issue generally agree with our analysis in the NPRM. Some commenters argue that incumbent LECs, including small incumbent LECs, should continue to receive access charge revenues when resellers purchase wholesale services under section 251(c)(4).[2307] The Rural Telephone Coalition argues that retail local service rates, upon which wholesale rates will be based, have been developed with the assumption that incumbent LECs will receive access charge revenues.[2308] The Wisconsin Commission points out that Wisconsin law currently prevents resale of access services performed by at least small LECs.[2309] On the other hand, the Texas Office of Public Utility Counsel asserts that switched access services are offered to end users and should be subject to resale.[2310] While they did not explicitly address the issue, some potential competitors alluded to their assumptions that such access charges would continue to be retained by the incumbent LEC.[2311]

3. Discussion

980. We conclude that the 1996 Act requires that incumbent LECs continue to receive access charge revenues when local services are resold under section 251(c)(4). IXCs must still

[2306] NPRM at para. 186.

[2307] Rural Tel. Coalition comments at 20; Citizens Utilities comments at 25; J. Staurulakis comments at 6.

[2308] Rural Tel. Coalition comments at 20. USTA makes a similar point, and emphasizes that incumbent LECs should continue to recover the SLC under these circumstances. USTA reply at 31.

[2309] Wisconsin Commission comments at Attachment, pp. 7-8.

[2310] Texas Public Utility Counsel reply at 17-18.

[2311] *See, e.g.*, TCC comments at 44 n.44; LDDS comments at 81; LDDS reply at 42, 46.

pay access charges to incumbent LECs for originating or terminating interstate traffic, even when their end user is served by a telecommunications carrier that resells incumbent LEC retail services. Resale, as defined in section 251(b)(1) and 251(c)(4), involves services, in contrast to section 251(c)(3), which governs sale of network elements. New entrants that purchase retail local exchange services from an incumbent LEC at wholesale rates are entitled to resell only those retail services, and not any other services -- such as exchange access -- the LEC may offer using the same facilities. IXCs must therefore still purchase access services from incumbent LECs outside of the resale framework of 251(c)(4), through existing interstate access tariffs.[2312]

981. Most existing interstate access charges are recovered from IXCs, and therefore can easily be recovered by incumbent LECs whether or not the incumbent LEC retains its billing relationship with the end user subscriber. To allow incumbent LECs to continue recovering the subscriber line charge (SLC), however, the mechanism for assessment of the SLC must be modified. The SLC is currently assessed directly on end users as a monthly charge.[2313] When an end user customer receives local exchange service from a reseller, however, the incumbent LEC will have no direct commercial relationship with that end user. Because the end user would not be a customer of the incumbent LEC, the incumbent LEC could not bill SLC directly to the end user as specified under our existing rules.

982. In March 1995, in the *Rochester Waiver Order*, we granted Rochester Telephone waivers to permit Rochester Telephone to recover the SLC from carriers that purchase local exchange service for resale, rather than recovering the SLC directly from end users.[2314] In that order, we stated that by offering the local exchange service for resale and by unbundling subscriber lines from other network functions, Rochester Telephone created a situation where it would no longer have a direct relationship with end users, IXCs, or both, and that such a situation was not contemplated when the Commission created the rules governing the recovery of access charges. We also permitted Rochester Telephone to bill to resellers the PIC change charge, which is assessed by incumbent local exchange carriers on end users that wish to change their primary interexchange carrier (PIC).

983. The resale requirements of the 1996 Act create a situation for the entire industry that is analogous to the situation Rochester Telephone faced in 1995. We therefore conclude that similar relief is warranted here with respect to the SLC, so that incumbent LECs can recover the SLC from resellers, as we conclude the 1996 Act mandates. Although the PIC change charge is

[2312] As discussed above, a different result occurs in the context of unbundled network elements. Purchasers of unbundled network elements in effect stand in the shoes of the LEC, and are entitled to revenues from all of the services provided using those elements.

[2313] 47 C.F.R. § 69.104.

[2314] *Rochester Telephone Corporation, Petition for Waivers to Implement its Open Market Plan, Order*, 10 FCC Rcd 6776 (1995) *(Rochester Waiver Order)*.

not a part of access charges, and is assessed only when an end user changes his or her primary interexchange carrier, this charge has similar characteristics to the SLC and therefore should also be subject to the rule we adopt. Incumbent LECs may assess the SLC and the PIC change charge on telecommunications carriers that resell incumbent LEC services under section 251(c)(4).

984. Although incumbent LECs may continue to recover the SLC when other carriers resell their local exchange services, the SLC is not subject to the wholesale pricing standard of section 252(d)(3). As described above, resellers of local exchange service are not reselling access services; they are purchasing these services from incumbent LECs in the same manner they do today. The SLC is a component of interstate access charges, not of intrastate local service rates. Consistent with the principles of cost-causation and economic efficiency, we have required the portion of interstate allocated loop costs represented by the SLC to be recovered from end users, rather than from carriers as with other access charges. Although the SLC is listed on end user monthly local service bills, this charge does not represent a "telecommunications service [an incumbent LEC] provides at retail to subscribers." Rather, the SLC, like other interstate access charges, relates solely to incumbent LEC interstate access services, which are provided to other carriers rather than retail subscribers and which we have concluded are not subject to the resale requirements of section 251(c)(4). Therefore, the reseller shall pay the SLC to the incumbent LEC for each subscriber taking resold service. The specific SLC that applies depends upon the identity of the end user served by the reselling telecommunications carrier.

IX. DUTIES IMPOSED ON "TELECOMMUNICATIONS CARRIERS" BY SECTION 251(a)

A. Background

985. Section 251(a) imposes two fundamental duties on all telecommunications carriers: (1) "to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers;" and (2) "not to install network features, functions, or capabilities that do not comply with the guidelines and standards established pursuant to sections 255 or 256."[2315] In this proceeding we determine which carriers are "telecommunications carriers" as defined in section 3(44) of the Act.[2316] In the NPRM, we tentatively concluded that, pursuant to the statute's definition of "telecommunications carrier" and "telecommunications service," to the extent a carrier is engaged in providing for a fee local, interexchange, or international services, directly to the public or to such classes of users as to be effectively available directly to the public, that carrier falls within the definition of "telecommunications carrier." We sought comment on which carriers are included under this definition, and on whether a provider may qualify as a telecommunications carrier for some purposes but not others.[2317]

986. We also tentatively concluded that we should determine whether the provision of mobile satellite services is Commercial Mobile Radio Services (CMRS) or Private Mobile Radio Service (PMRS) based on the factors set forth in the *CMRS Second Report and Order*.[2318] We

[2315] 47 U.S.C. § 251(a). Section 255 addresses access by persons with disabilities and ensures that manufacturers and providers of telecommunications will design equipment and provide service that is accessible to, and usable by, individuals with disabilities. Section 256 provides for coordination for interconnectivity "to promote nondiscriminatory accessibility by the broadest number of users and vendors of communications products and services." 47 U.S.C. §§ 255, 256.

[2316] The term telecommunications carrier means "any provider of telecommunications services, except that such term does not include aggregators of telecommunications services (as defined in section 226). A telecommunications carrier shall be treated as a common carrier under this Act only to the extent that it is engaged in providing telecommunications services, except that the Commission shall determine whether the provision of fixed and mobile satellite service shall be treated as common carriage." 47 U.S.C. § 153(44).

[2317] NPRM at para. 246.

[2318] NPRM at para. 247. The Commission makes this determination by looking at an array of public interest considerations (*e.g.*, the types of services being offered and the number of licensees being authorized). *See, e.g., Amendment of Parts 2, 22 and 25 of the Commission's Rules to Allocate Spectrum for, and To Establish Other Rules and Policies Pertaining to the Use of Radio Frequencies in a Land Mobile Satellite Service for the Provision of Various Common Carrier Services*, GN Docket No. 84-1234, Second Report and Order, 2 FCC Rcd 485, 490 (1987); *Amendment to the Commission's Rules to Allocate Spectrum for, and to Establish Other Rules and Policies Pertaining to a Radiodetermination Satellite Service*, GN Docket No. 84-689, Second Report and Order, 104 FCC 2d 650, 665-66 (1986).

sought comment on the meaning of offering service "directly or indirectly" to the public in the context of section 251(a)(1) and on whether section 251(a) allows non-incumbent LECs discretion to interconnect directly or indirectly with a requesting carrier.[2319] We also sought comment on what other actions we should take to ensure that carriers do not install network features, functions, or capabilities that are inconsistent with guidelines and standards established pursuant to sections 255 and 256.

B. Comments

987. Parties generally agree with our tentative conclusion that, to the extent a carrier is engaged in providing for a fee local, interexchange, or international services, directly to the public or to such classes of users as to be effectively available to the public, that carrier falls within the definition of "telecommunications carrier."[2320] BellSouth claims that the term "telecommunications carrier" should be synonymous with "common carrier."[2321] The Texas Commission argues that the obligations of section 251(a) should apply to all telecommunications carriers -- incumbent LECs and non-incumbent LECs alike.[2322] Metricom argues, however, that because non-dominant carriers lack incentives to deny interconnection to other carriers, the Commission should forbear from imposing any interconnection requirements upon such carriers.[2323] UTC argues that a party must be offering commercial telecommunications services to be a telecommunications carrier.[2324] UTC contends that utilities and other private system operators engage in a cost-sharing for construction and operation of private telecommunications networks. UTC claims that this should not constitute a "fee" in the sense of being a payment for receiving a telecommunications service. UTC further argues that the mere provision of infrastructure, such as "dark fiber" or wholesale capacity, to third-party carriers does not constitute a direct offering to the public, and thus does not qualify carriers offering such infrastructure as telecommunications carriers under the Act. Several CMRS carriers contend that

[2319] NPRM at para 248.

[2320] *See, e.g.*, Louisiana Commission comments at 21; Illinois Commission comments at 81-82; Pennsylvania Commission comments at 41; BellSouth comments at 75.

[2321] BellSouth comments at 75; COMAV comments at 60; *accord* United Cerebral Palsy Ass'n at 3 and American Foundation for the Blind at 3 (favoring a broad definition of telecommunications carrier that includes any provider of access to any network available to the public).

[2322] Texas Commission comments at 34; NWRA comments at 12-13 (arguing that both facilities based carriers and resellers meet the definition of telecommunications carriers).

[2323] Metricom comments at 3.

[2324] UTC comments at 5-7.

CMRS providers are telecommunications carriers within the meaning of the Act.[2325]

988. The Illinois Commission argues that, if a company provides both telecommunications and information services, it must be classified as a telecommunications carrier for purposes of section 251.[2326] BellSouth claims, however, that a carrier may be a common carrier for some purposes, but not for others. For example, BellSouth argues that, when a common carrier also provides an information service, it is a common carrier for the provision of the telecommunications service, but a non-common carrier for the provision of the information service.[2327] ATSI contends that enhanced service providers are telecommunications carriers and entitled to the benefits of section 251.[2328]

989. The Illinois Commission argues that the Commission should continue to define mobile satellite service (MSS) as either CMRS or PMRS according to the Commission's factors set forth in the *Second CMRS Report and Order*.[2329] It argues, however, that if an MSS provider offers substitute services for those of a landline LEC, the MSS provider should also be defined as a LEC and treated accordingly under state and federal law.

990. With regard to the phrase "directly or indirectly" in section 251(a), Arch and Sprint argue that the goal is to ensure that all subscribers of one carrier are able to reach all subscribers of other carriers. They claim that this is achieved when two competitors interconnect to an incumbent LEC's network.[2330] Comcast asserts that requiring competitors to interconnect "directly or indirectly" reflects the Act's goal of applying less stringent obligations to carriers lacking market power by enabling competitors to interconnect with other carriers in a cost efficient

[2325] *See, e.g.*, Nextel comments at 6-7; NWRA comments at 12-13; Metricom comments at 1-7; COMAV comments at 60.

[2326] Illinois Commission comments at 81.

[2327] BellSouth comments at 75. UTC claims that only those portions of a Utility's network that is being used in the offering of telecommunications services is subject to the Act's interconnection obligations. Portions that are used on a private basis only are not. Bundling information services with telecommunications services should only create common carrier obligations to the extent that would apply if the telecommunications services were offered by themselves. UTC comments at 9-10.

[2328] ATSI reply at 6 (enhanced service providers (ESPs) must have access to network elements at terms and conditions that allow ESPs to offer competitive services in the marketplace).

[2329] Illinois Commission comments at 81.

[2330] Arch comments at 18; Sprint comments at 89. The parties add that carriers should be permitted, on a voluntary basis, to establish direct interconnection. *Id.*

manner.[2331] The Texas Commission argues that the obligations under section 251(a) should apply to all telecommunications carriers, incumbent and non-incumbents, alike. The Texas Commission claims that, if "non-[incumbent] LECs are allowed the discretion to determine whether to offer direct or indirect connection to another carrier, then the goal of encouraging the most efficient interconnection and thereby bringing the benefits of a competitive market to all consumers will not be realized."[2332]

991. The Commission received few comments on the meaning of section 251(a)(2). Commenters representing individuals with disabilities state that the term "network features, functions, and capabilities" should be defined as broadly as possible to ensure that individuals with disabilities have access to the network.[2333] The American Foundation for the Blind also suggests that any service deployed by a telecommunications carrier, or by a provider connecting to a telecommunications network, and intended for public use should be considered an installation of "features, functions, or capabilities."[2334] The United Cerebral Palsy Associations state that there are currently proceedings underway by both the Commission and by the United States Architectural & Transportation Barriers Compliance Board (Access Board) as part of the section 255 mandate. The United Cerebral Palsy Associations urge the Commission to state that the Commission has the power to enforce both the standards developed in its proceedings and those of the Access Board.[2335]

C. Discussion

992. A "telecommunications carrier" is defined as "any provider of telecommunications services, except that such term does not include aggregators of telecommunications services (as defined in section 226)."[2336] A telecommunications carrier shall be treated as a common carrier under the Act "only to the extent that it is engaged in providing telecommunications services, except that the Commission shall determine whether the provision of fixed and mobile satellite service shall be treated as common carriage."[2337] A "telecommunications service" is defined as

[2331] Comcast comments at 16-17.

[2332] Texas Commission comments at 34.

[2333] *See, e.g.*, American Foundation for the Blind comments at 2; United Cerebral Palsy Ass'n comments at 2.

[2334] American Foundation for the Blind comments at 2.

[2335] United Cerebral Palsy Ass'n comments at 2.

[2336] 47 U.S.C. § 153(44). The term "aggregator" is defined as "any person that, in the ordinary course of its operations, makes telephones available to the public or to transient users of its premises, for interstate telephone calls using a provider of operator services." 47 U.S.C. § 226(a)(2).

[2337] 47 U.S.C. § 153 (44).

the "offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used."[2338] We conclude that to the extent a carrier is engaged in providing for a fee domestic or international telecommunications, directly to the public or to such classes of users as to be effectively available directly to the public, the carrier falls within the definition of "telecommunications carrier."[2339] We find that this definition is consistent with the 1996 Act,[2340] and there is nothing in the record in this proceeding that suggests that this definition should not be adopted. Also, enhanced service providers, to the extent that they are providing telecommunications services, are entitled to the rights under section 251(a).

993. We believe, as a general policy matter, that all telecommunications carriers that compete with each other should be treated alike regardless of the technology used unless there is a compelling reason to do otherwise. We agree with those parties that argue that all CMRS providers are telecommunications carriers and are thus obligated to comply with section 251(a).[2341] These carriers meet the definition of "telecommunications carrier" because they are providers of telecommunications services as defined in the 1996 Act and are thus entitled to the benefits of section 251(c), which include the right to request interconnection and obtain access to unbundled elements at any technically feasible point in an incumbent LEC's network. PMRS is defined as any mobile service that is not a commercial service or the functional equivalent of a commercial mobile service.[2342] We conclude that to the extent a PMRS provider uses capacity to provide domestic or international telecommunications for a fee directly to the public, it will fall within the definition of "telecommunications carrier" under the Act and will be subject to the duties listed in section 251(a).[2343]

[2338] 47 U.S.C. § 153(44). "Telecommunications" is defined in the Act as "the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." 47 U.S.C. § 153(43).

[2339] NPRM at para. 246.

[2340] 47 U.S.C. § 153(44), 153(46).

[2341] The term "CMRS" is defined as "any mobile service . . . that is provided for profit and makes interconnected service available (A) to the public or (B) to such classes of eligible users as to be effectively available to a substantial portion of the public." 47 U.S.C. § 332(d)(1). CMRS includes, among others, some private paging, personal communications services, business radio services, and mobile service that is the functional equivalent of a commercial mobile radio service. 47 C.F.R. § 20.9.

[2342] 47 U.S.C. § 332(d)(3).

[2343] The Commission held in the *CMRS Second Report and Order* that any PMRS provider that "employs spectrum for not-for-profit services, such as an internal operation, but also uses its excess capacity to make available a service that is intended to receive compensation, will be deemed to be a 'for profit' service to the extent of such excess capacity activities." *Implementation of Section 3(n) and 332 of the Communications Act*, Second Report and

994. We conclude that cost-sharing for the construction and operation of private telecommunications networks is not within the definition of "telecommunications services" and thus such operators of private networks are not subject to the requirements of section 251(a). We believe that such methods of cost-sharing do not equate to a "fee directly to the public" under the definition of "telecommunications service."[2344] Conversely, to the extent an operator of a private telecommunications network is offering "telecommunications"[2345] for a fee directly to the public, or to such classes of users as to be effectively available directly to the public (*i.e.*, providing a telecommunications service),[2346] the operator is a telecommunications carrier and is subject to the duties in section 251(a). Providing to the public telecommunications (*e.g.*, selling excess capacity on private fiber or wireless networks), constitutes a telecommunications service and thus subjects the operator of such a network to the duties of section 251(a) to that extent.

995. We conclude that, if a company provides both telecommunications and information services, it must be classified as a telecommunications carrier for purposes of section 251, and is subject to the obligations under section 251(a), to the extent that it is acting as a telecommunications carrier. We also conclude that telecommunications carriers that have interconnected or gained access under sections 251(a)(1), 251(c)(2), or 251(c)(3), may offer information services through the same arrangement, so long as they are offering telecommunications services through the same arrangement as well. Under a contrary conclusion, a competitor would be precluded from offering information services in competition with the incumbent LEC under the same arrangement, thus increasing the transaction cost for the competitor. We find this to be contrary to the pro-competitive spirit of the 1996 Act. By rejecting this outcome we provide competitors the opportunity to compete effectively with the incumbent by offering a full range of services to end users without having to provide some services inefficiently through distinct facilities or agreements. In addition, we conclude that enhanced service providers that do not also provide domestic or international telecommunications, and are thus not telecommunications carriers within the meaning of the Act, may not interconnect under section 251.

996. Consistent with our tentative conclusion in the NPRM, we will determine whether the provision of mobile satellite service (MSS) is CMRS (and therefore common carriage) or

---

Order, GN Docket No. 93-252, 9 FCC Rcd 1411, 1429 (1994) *(CMRS Second Report and Order)*.

[2344] 47 U.S.C. § 153(46).

[2345] The term "telecommunications" means "the transmission, between or among points specified by the user, of information of the user's choosing, without change in form or content of the information as sent and received." 47 U.S.C. § 153(43).

[2346] 47 U.S.C. § 153(46).

PMRS based on the factors set forth in the *CMRS Second Report and Order*.[2347] Commenters have not raised objections to the Commission's tentative conclusion on this issue.

997. Regarding the issue of interconnecting "directly or indirectly" with the facilities of other telecommunications carriers, we conclude that telecommunications carriers should be permitted to provide interconnection pursuant to section 251(a) either directly or indirectly, based upon their most efficient technical and economic choices. The interconnection obligations under section 251(a) differ from the obligations under section 251(c). Unlike section 251(c), which applies to incumbent LECs, section 251(a) interconnection applies to all telecommunications carriers including those with no market power. Given the lack of market power by telecommunication carriers required to provide interconnection via section 251(a), and the clear language of the statute, we find that indirect connection (*e.g.*, two non-incumbent LECs interconnecting with an incumbent LEC's network) satisfies a telecommunications carrier's duty to interconnect pursuant to section 251(a). We decline to adopt, at this time, Metricom's suggestion to forbear under section 10 of the 1996 Act[2348] from imposing any interconnection requirements upon non-dominant carriers. We believe that, even for telecommunications carriers with no market power, the duty to interconnect directly or indirectly is central to the 1996 Act and achieves important policy objectives. Nothing in the record convinces us that we should forbear from imposing the provisions of section 251(a) on non-dominant carriers. In fact, section 251 distinguishes between dominant and non-dominant carriers, and imposes a number of additional obligations exclusively on incumbent LECs.[2349] Similarly, we also do not agree with the Texas Commission's argument that the obligations of section 251(a) should apply equally to all telecommunications carriers. Section 251 is clear in imposing different obligations on carriers depending upon their classification (*i.e.*, incumbent LEC, LEC, or telecommunications carrier).[2350] For example, section 251(c) specifically imposes obligations upon incumbent LECs to interconnect, upon request, at all technically feasible points. This direct interconnection, however, is not required under section 251(a) of all telecommunications carriers.

998. Section 251(a)(2) prohibits telecommunications carriers from installing network features, functions, and capabilities that do not comply with standards or guidelines established under sections 255 and 256. Because the Commission and the Architectural and Transportation Barriers Compliance Board have not developed standards or guidelines under section 255, we find that it would be premature at this point to attempt to delineate specific requirements or definitions

[2347] *CMRS Second Report and Order*, 9 FCC Rcd at 1457-58 (1994).

[2348] 47 U.S.C. § 160.

[2349] *See* 47 U.S.C. § 251. The 1996 Act makes further provisions for rural carriers and, upon an appropriate showing, carriers serving fewer than 2 percent of the nation's access lines. *See* 47 U.S.C. § 251(f)(1), (f)(2).

[2350] 47 U.S.C. § 251.

of terms to implement Section 251(a)(2).[2351] Similarly, the Commission has asked its federal advisory committee, the Network Reliability and Interoperability Council, for recommendations on how the Commission should implement Section 256. We intend to issue a further notice of proposed rulemaking seeking comment on what accessibility and compatibility requirements apply to telecommunications carriers who install network features, functions and capabilities.

[2351] The Illinois Commission lists several features which could provide access to individuals with disabilities, such as access to interrupt messages, directory assistance and operator services by users of text telephones (TTYs). Illinois Commission comments at 82-83. Specific accessibility requirements such as those proposed by the Illinois Commission will need to be developed in proceedings to implement section 255, and therefore, we will not set forth any required "features, functions, or capabilities" in this proceeding.

X. COMMERCIAL MOBILE RADIO SERVICE INTERCONNECTION

999. In the NPRM, we sought comment on whether interconnection arrangements between incumbent LECs and CMRS providers fall within the scope of sections 251 and 252. Application of sections 251 and 252 to LEC-CMRS interconnection arrangements involves two distinct issues. One is whether the terms and conditions of the physical interconnection between incumbent LECs and CMRS providers are governed under section 251(c)(2), and the corresponding pricing standards set forth in section 252(d)(1). The second, and perhaps more critical issue from the CMRS providers' perspective, is whether CMRS providers are entitled to reciprocal compensation for transport and termination under section 251(b)(5), and the corresponding pricing standards set forth in section 252(d)(2).[2352]

1000. We tentatively concluded in the NPRM that CMRS providers are not obliged to provide to requesting telecommunications carriers either reciprocal compensation for transport and termination of telecommunications under section 251(b)(5), or interconnection under the provisions of section 251(c)(2), but that CMRS providers may be entitled to request interconnection under section 251(c)(2) for the purposes of providing "telephone exchange service and exchange access."[2353] We sought comment on this tentative conclusion. We also asked for comment on the separate but related question of whether LEC-CMRS transport and termination arrangements fall within the scope of section 251(b)(5). In addition, we sought comment on the relationship between section 251 and section 332(c).[2354] We acknowledged that issues relating to LEC-CMRS interconnection pursuant to section 332(c) were part of an ongoing proceeding initiated before the passage of the 1996 Act[2355] and retained the prerogative of incorporating by reference the comments filed in that docket to the extent necessary. We hereby do so.

[2352] 47 U.S.C. §§ 251, 252.

[2353] 47 U.S.C. §§ 251(b)(5), 251(c)(2).

[2354] 47 U.S.C. §332(c). This section sets forth the regulatory treatment for mobile services, including the common carrier treatment of CMRS providers (except for such provisions of Title II as the Commission may specify), the right of CMRS providers to request (and the Commission to order) physical interconnection with other common carriers and the preemption of state regulation of the entry of or the rates charged by any CMRS providers.

[2355] *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, Notice of Proposed Rulemaking, CC Docket No. 95-185, 11 FCC Rcd 5020 (1996) (*LEC-CMRS Interconnection NPRM*).

A. CMRS Providers and Obligations of Local Exchange Carriers Under Section 251(b) and Incumbent Local Exchange Carriers Under Section 251(c).

1. Background

1001. Section 251(b) imposes duties only on LECs, and section 251(c) imposes duties only on incumbent LECs. Section 3(26) of the Act defines "local exchange carrier" to mean "any person that is engaged in the provision of telephone exchange service or exchange access," but "does not include a person insofar as such person is engaged in the provision of a commercial mobile service under section 332(c), except to the extent that the Commission finds that such service should be included in the definition of such term."[2356] In the NPRM, we sought comment on whether, and to what extent, CMRS providers should be classified as "local exchange carriers" and therefore subject to the duties and obligations imposed by section 251(b).

2. Comments

1002. Most of the comments on this issue urge that CMRS providers should not be classified as LECs.[2357] Some commenters assert that CMRS was expressly excluded from the definition of a LEC in section 3(a)(2)(44) of the 1996 Act and that the legislative history confirms that Congress intended that the Commission reconsider whether CMRS providers should be classified as LECs only if "future circumstances warrant."[2358] PCIA maintains that there is no basis for classifying CMRS providers as LECs, because CMRS is not yet a substitute for wireline local exchange service for a substantial number of subscribers, and because CMRS licensees lack the control over essential facilities that underlies the adoption of Section 251.[2359] Pronet contends that paging operators do not provide local exchange services, and that Congress did not contemplate treating CMRS providers as LECs.[2360] Some CMRS providers propose that the Commission apply the criteria in section 332(c)(3) in considering whether a CMRS provider should be classified as a LEC -- that the service is a replacement for a substantial portion of the

[2356] 47 U.S.C. § 153(26).

[2357] 360 Communications comments at 9; Airtouch comments at 9; Bell Atlantic/NYNEX Mobile comments at 5; F. Williamson comments at 8-9; Cox comments at 50-51; PCIA comments at 16.

[2358] *See, e.g.*, Airtouch reply at 4-6 (*citing* H.R. Rep. No. 104-458, 104th Cong., 2d Sess. 115 (1996)); PCIA reply at 6; Bell Atlantic/NYNEX Mobile comments at 4-5; PCIA comments at 16; GTE reply at 40 (Commission already found that CMRS providers should not be regulated as LECs for the purpose of interconnection and the 1996 Act does nothing to alter this conclusion).

[2359] PCIA comments at 17; *accord* Nextel comments at 6.

[2360] Pronet comments at 8.

wireline telephone exchange service within a state.[2361] Nextel argues that a CMRS provider should not be classified as a LEC until it has become a substitute for a land-line telephone exchange service for a substantial portion of the communications within a state.[2362] Omnipoint states that application of the section 332(c)(3) test will permit CMRS providers, which are also small businesses, to be relieved of LEC-type regulatory burdens during their initial entry years, so that they can act as "spirited, if smaller" competitors to the incumbent LEC.[2363] The Ohio Commission contends that the Commission should consider market share, diversity of network, and name recognition in classifying CMRS providers as LECs.[2364]

1003. COMAV and National Wireless Resellers Association, on the other hand, contend that CMRS entities can provide exchange and exchange access services "and thus are *de facto*" LECs.[2365] COMAV also argues that, if a CMRS provider is a subsidiary of an incumbent LEC, it should be treated as an incumbent LEC, and thus be required to unbundle and allow direct interconnection.[2366] NARUC argues that the type of service provided, rather than the technology employed, should determine the appropriate regulatory treatment, and that a CMRS provider should therefore be treated as a LEC if it provides fixed local service.[2367] The Illinois Commission similarly indicates that a CMRS provider should be regulated as a LEC when it establishes a wireless local loop for the express purpose of competing against or bypassing the landline loop.[2368]

3. Discussion

1004. We are not persuaded by those arguing that CMRS providers should be treated as LECs, and decline at this time to treat CMRS providers as LECs. Section 3(26) of the Act, quoted above, makes clear that CMRS providers should not be classified as LECs until the Commission makes a finding that such treatment is warranted. We disagree with COMAV and National Wireless Resellers Association that CMRS providers are *de facto* LECs (and even

[2361] Cox comments at 51 n.96; Omnipoint comments at 2; Vanguard comments at 21; BellSouth comments at 70; 360 Communications comments at 9; Bell Atlantic/NYNEX Mobile comments at 5.

[2362] Nextel reply at 2.

[2363] Omnipoint comments at 3-4.

[2364] Ohio Commission comments at 68.

[2365] COMAV comments at 2; National Wireless Resellers Assn comments at 7-10.

[2366] COMAV comments at 2, 40-43.

[2367] NARUC comments at 21.

[2368] Illinois Commission comments at 63-64.

incumbent LECs if they are affiliated with a LEC) simply because they provide telephone exchange and exchange access services. Congress recognized that some CMRS providers offer telephone exchange and exchange access services, and concluded that their provision of such services, by itself, did not require CMRS providers to be classified as LECs. We further note that, because the determination as to whether CMRS providers should be defined as LECs is within the Commission's sole discretion, states are preempted from requiring CMRS providers to classify themselves as "local exchange carriers" or be subject to rate and entry regulation as a precondition to participation in interconnection negotiations and arbitrations under sections 251 and 252.

1005. NARUC argues that CMRS providers should be classified as LECs if they provide fixed service.[2369] We are currently seeking comment in our *CMRS Flexibility Proceeding*[2370] on the regulatory treatment to be afforded CMRS providers when they provide fixed services. Thus, we believe that it would be premature to answer that question here, based only on the record in this proceeding. We also decline to adopt the Illinois Commission's suggestion that we find that a CMRS provider is a LEC if the CMRS provider seeks to compete directly with a wireline LEC. Even if we were to accept the Illinois Commission's underlying assumption, the record in this proceeding contains no evidence that wireless local loops have begun to replace wireline loops for the provision of local exchange service. Thus, until such time that we decide otherwise, CMRS providers will not be classified as LECs, and are not subject to the obligations of section 251(b). We further note that, even if we were to classify some CMRS providers as LECs, other types of CMRS providers, such as paging providers, might not be so classified because they do not offer local exchange service or exchange access.

1006. We further note that, because CMRS providers do not fall within the definition of a LEC under section 251(h)(1), they are not subject to the duties and obligations imposed on incumbent LECs under section 251(c).[2371] An incumbent LEC is defined in section 251(h)(1), and includes only those LECs that were, on the date of enactment of the 1996 Act, deemed to be members of NECA pursuant to 47 C.F.R. § 69.601(b), or the successor or assign of a NECA member. Similarly, we do not find that CMRS providers satisfy the criteria set forth in section 251(h)(2), which grants the Commission the discretion to, by rule, provide for the treatment of a LEC as an incumbent LEC if certain conditions are met.[2372]

[2369] NARUC comments at 21.

[2370] *Amendment of the Commission's Rules to Permit Flexible Service Offerings in the Commercial Mobile Radio Services*, WT Docket No. 96-6, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-283 (released August 1, 1996).

[2371] 47 U.S.C. § 251(h)(1). *See infra*, Section XI.C.

[2372] 47 U.S.C. § 251(h)(2). *See infra*, Section XI.C.

B. Reciprocal Compensation Arrangements Under Section 251(b)(5)

1007. Some parties contend that LEC-CMRS transport and termination arrangements do not fall within the scope of 251(b)(5), which requires LECs to establish reciprocal compensation arrangements for transport and termination.[2373] Other commenters argue that because CMRS providers fall within the definition of "telecommunications carriers," they fall within the scope of section 251(b)(5).[2374]

1008. Under section 251(b)(5), LECs have a duty to establish reciprocal compensation arrangements for the transport and termination of "telecommunications."[2375] Under section 3(43), "[t]he term 'telecommunications' means the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received."[2376] All CMRS providers offer telecommunications. Accordingly, LECs are obligated, pursuant to section 251(b)(5) (and the corresponding pricing standards of section 252(d)(2)), to enter into reciprocal compensation arrangements with all CMRS providers, including paging providers, for the transport and termination of traffic on each other's networks, pursuant to the rules governing reciprocal compensation set forth in Section XI.B., below.

C. Interconnection Under Section 251(c)(2)

1. Background

1009. Section 251(c)(2)(A) provides that an incumbent LEC must provide interconnection with its local exchange network to "any requesting telecommunications carrier . . . for the transmission and routing of telephone exchange service and exchange access."[2377] In the NPRM, we tentatively concluded that CMRS providers may be entitled to request interconnection under section 251(c)(2) for the purposes of providing telephone exchange service and exchange access.[2378] We sought comment on this tentative conclusion.

2. Comments

[2373] PCIA comments at 13; PageNet comments at 10; APC comments at 1.

[2374] BellSouth comments at 63; National Wireless Resellers Assn comments at 7; Mobilemedia comments at 13.

[2375] 47 U.S.C. § 251(b)(5).

[2376] 47 U.S.C. § 153(43).

[2377] 47 U.S.C. § 251(c)(2)(A).

[2378] 47 U.S.C. § 251(c)(2).

1010. Several commenters argue that many CMRS providers provide telephone exchange service and exchange access as defined by the 1996 Act, and thus section 251(c)(2) should govern their interconnection arrangements with incumbent LECs.[2379] NYNEX contends that all CMRS providers, other than providers of one-way paging, provide telephone exchange service.[2380] The Ohio Commission contends that all voice grade CMRS providers which provide local exchange service may request interconnection under section 251(c)(2).[2381] The Pennsylvania Commission argues that all voice-grade and non-voice grade CMRS providers fit within the definition of telecommunications carriers and fall within the parameters of section 251(c)(2).[2382]

1011. Many wireless carriers argue that interconnection arrangements between incumbent LECs and CMRS providers do not fall within the scope of section 251(c)(2).[2383] CTIA claims that CMRS was intended to be regulated differently than other services because it entails different traffic flows and different termination costs.[2384] Airtouch claims that, if LEC-CMRS interconnection were found to fall within the scope of section 251, the concept of "local exchange areas" could create implementation problems and adverse policy results, thus supporting application of section 332(c)(1)(B).[2385]

3. Discussion

1012. As discussed in the preceding section, CMRS providers meet the statutory definition of "telecommunications carriers."[2386] We also agree with several commenters that many CMRS providers (specifically cellular, broadband PCS and covered SMR) also provide telephone

[2379] *See, e.g.*, Pennsylvania Commission comments at 34; PacTel comments at 83; Bell Atlantic/NYNEX Mobile comments at 7; Nextel comments at 6-7; API comments at 3; Florida Commission comments at 35-36.

[2380] NYNEX comments at 23.

[2381] Ohio Commission comments at 59.

[2382] Pennsylvania Commission comments at 34.

[2383] *See, e.g.*, AT&T comments at 43; Sprint comments at 70; Bell Atlantic/NYNEX Mobile comments at 2; CTIA comments at 2-3; Nextel comments at 5-6; Omnipoint comments at 3-5; Vanguard comments at 20-22; MECA comments at 59; Arch comments at 12-13; Airtouch reply at 3; Sprint/APC comments at 2-3 (Congress crafted a definition of "local exchange carrier" that excluded CMRS indicating that it did not want CMRS providers treated with all providers of telecommunications services). Sprint/APC claim in their joint comments that it is clear from the 1996 Act as a whole, and from section 332(c), that CMRS providers are entitled to reasonable interconnection from LECs without regard to section 251. Sprint/APC comments at 5.

[2384] CTIA comments at 7; Sprint/APC comments at 3.

[2385] Airtouch reply at 7.

[2386] *See supra*, Section IX.

exchange service and exchange access as defined by the 1996 Act. Incumbent LECs must accordingly make interconnection available to these CMRS providers in conformity with the terms of sections 251(c) and 252, including offering rates, terms, and conditions that are just, reasonable and nondiscriminatory.[2387]

1013. The 1996 Act defines "telephone exchange service" as "service within a telephone exchange, or within a connected system of telephone exchanges within the same exchange area . . . and which is covered by the exchange service charge, *or (B) comparable service* provided through a system of switches, transmission equipment, or other facilities (or combination thereof) by which a subscriber can originate and terminate a telecommunications service."[2388] At a minimum, we find that cellular, broadband PCS, and covered SMR providers fall within the second part of the definition because they provide "comparable service" to telephone exchange service. The services offered by cellular, broadband PCS, and covered SMR providers are comparable because, as a general matter, and as some commenters note, these CMRS carriers provide local, two-way switched voice service as a principal part of their business.[2389] Indeed, the Commission has described cellular service as exchange telephone service[2390] and cellular carriers as "generally engaged in the provision of local exchange telecommunications in conjunction with local telephone companies . . . ."[2391] In addition, although CMRS providers are not currently classified as LECs, the fact that most CMRS providers are capable, both technically and pursuant to the terms of their licenses, of providing fixed services, as LECs do, buttresses our conclusion that these CMRS providers offer services that are "comparable" to telephone exchange service and supports the notion that these services may become a true economic substitute for wireline local

[2387] 47 U.S.C. § 251(c)(2)(D).

[2388] 47 U.S.C. § 153(47) (emphasis added). This is a broader definition of "telephone exchange service" than had previously existed; Congress changed the definition in the 1996 Act to include services "comparable" to telephone exchange.

[2389] *See, e.g.*, NYNEX comments at 23.

[2390] *See Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carriers*, Memorandum Opinion and Order, 59 Rad. Reg.2d 1275, 1278 (1986).

[2391] *In the Matter of the Need to Promote Competition and Efficient Use of Spectrum For Radio Common Carrier Services*, Memorandum Opinion and Order, 59 Rad. Reg. 2d 1275, 1278 (1986) (*Competition Opinion*); *see also id.* at 1284 (cellular carriers are primarily engaged in the provision of local, intrastate exchange telephone service); *Equal Access and Interconnection Obligations Pertaining to Commercial Radio Services*, CC Docket No. 94-54, Notice of Proposed Rulemaking and Notice of Inquiry, 9 FCC Rcd 5408, 5453 and nn.192, 195 (and cases cited therein) (1994).

exchange service in the future.[2392]

1014. We also believe that other definitions in the Act support the conclusion that cellular, broadband PCS, and covered SMR licensees provide telephone exchange service. The fact that the 1996 Act's definition of a LEC excludes CMRS until the Commission finds that such service should be included in the definition,"[2393] suggests that Congress found that some CMRS providers were providing telephone exchange service or exchange access, but sought to afford the Commission the discretion to decide whether CMRS providers should be treated as LECs under the new Act. Similarly, section 253(f) permits the states to impose certain obligations on "telecommunications carrier[s] that seek[ ] to provide telephone exchange service" in rural areas.[2394] The provision further provides that "[t]his subsection shall not apply . . . to a provider of commercial mobile services."[2395] It would have been unnecessary for the statute to include this exception if some CMRS were not telephone exchange service. Similarly, section 271(c)(1)(A), which sets forth conditions for determining the presence of a facilities-based competitor for purposes of BOC applications to provide in-region, interLATA services, provides that Part 22 [cellular] services "shall not be considered to be telephone exchange services," for purposes of that section.[2396] Again, if Congress did not believe that cellular providers were engaged in the provision of telephone exchange service, it would not have been necessary to exclude cellular providers from this provision.

1015. The arguments that CMRS traffic flows may differ from wireline traffic, that CMRS providers' termination costs may differ from LECs, that CMRS service areas do not coincide with wireline local exchange areas, or that CMRS providers are not LECs, do not alter our conclusion that cellular, broadband PCS, and covered SMR licensees provide telephone exchange service. These considerations are not relevant to the statutory definition of telephone exchange service in section 3(47). Incumbent LECs are required to provide interconnection to CMRS providers who request it for the transmission and routing of telephone exchange service or exchange access, under the plain language of section 251(c)(2).[2397]

[2392] *See Amendment of the Commission's Rules to Permit Flexible Service Offerings in the Commercial Mobile Radio Services*, WT Docket No. 96-6, First Report and Order and Further Notice of Proposed Rulemaking, FCC 96-283 (released August 1, 1996)(amending rules to allow providers of narrowband and broadband PCS, cellular, CMRS SMR, CMRS paging, CMRS 220 MHz service, and for-profit interconnected business radio services to offer fixed wireless services on their assigned spectrum on a co-primary basis with mobile services).

[2393] 47 U.S.C. § 153(26).

[2394] 47 U.S.C. § 253(f).

[2395] *Id.*

[2396] 47 U.S.C. § 271(c)(1)(A).

[2397] 47 U.S.C. § 251(c)(2).

D. Jurisdictional Authority for Regulation of LEC-CMRS Interconnection Rates

1. Background

1016. In the NPRM, we sought comment on the relationship between section 251 and section 332(c).[2398] As noted above, we hereby incorporate by reference the comments filed in CC Docket No. 95-185 to the extent relevant to our analysis. In the NPRM, we noted that we had previously sought comment on the relationship of these two statutory provisions in the LEC-CMRS Interconnection proceeding.[2399] In the LEC-CMRS proceeding, we tentatively concluded that the Commission has sufficient authority to promulgate specific federal requirements for interstate and intrastate LEC-CMRS interconnection arrangements, including the adoption of a specific interim bill and keep arrangement.[2400] However, we reached that tentative conclusion before the enactment of the 1996 Act.

2. Comments

1017. Several wireless firms argue that LEC-CMRS interconnection rates are governed by section 332 rather than (or in addition to) sections 251 and 252.[2401] One argument advanced by some parties is that section 251(i), which provides that "[n]othing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201,"[2402] preserves the Commission's authority over interstate interconnection under section 201.[2403] Thus, they argue, section 251(i) enables the Commission to not apply sections 251 and 252 whenever interstate services are at issue.[2404] Cox states that, because "Section 251 does not prevent the Commission from establishing an interconnection policy for LEC-to-CMRS traffic under its general Section 201 powers, Section 252 has no particular relevance for any interconnection

[2398] 47 U.S.C. § 332.

[2399] NPRM at para. 169.

[2400] *Id.* at 5072-73.

[2401] *See, e.g.*, AT&T comments at 42; Airtouch comments at 5; Cox comments at 50; CTIA reply at 2; PCIA comments at 3-9.

[2402] 47 U.S.C. § 251(i).

[2403] *See, e.g.*, Cox comments in CC Docket No. 95-185 at 43-44; CTIA comments in CC Docket No. 95-185 at 62; Omnipoint comments at 12; Vanguard Cellular comments at 15.

[2404] Cox comments in CC Docket No. 95-185 at 43-44.

policy established by this proceeding."[2405]

1018. Another theory proposed by several wireless carriers is that section 332 makes all CMRS interconnection issues interstate, including interconnection rates, and thus all CMRS interconnection matters are subject to federal jurisdiction under section 201, and are not governed by sections 251 and 252.[2406] These parties assert that, prior to the 1993 Budget Act, the Commission did not exercise any authority over the intrastate rates of LEC interconnection provided to radio common carriers, but that the 1993 Budget Act changed the Commission's jurisdiction over LEC-CMRS interconnection rates.[2407] Parties rely on two provisions amended or added by the 1993 Budget Act to reach this conclusion. First, they point to section 332(c)(3), entitled "State Preemption," which provides in pertinent part that "*[n]otwithstanding section[ ] 2(b) . . .*, no State or local government shall have any authority to regulate the entry of or *the rates charged by any commercial mobile service* or any private mobile service, except that this paragraph shall not prohibit a State from regulating the other terms and conditions of commercial mobile services."[2408] Second, commenters point to a limiting clause added to section 2(b), which provides that: "*[e]xcept as provided in section 223 through 227, inclusive, and section 332 . . .*, nothing in this Act shall be construed to apply or to give the Commission jurisdiction [over intrastate telecommunications]."[2409] Cox interprets these cross-references to mean that, "[u]nder this revised framework, the States retain jurisdiction to regulate the 'terms and conditions' of CMRS service delivered to end users and can petition the Commission to regulate CMRS rates when CMRS becomes a substitute for landline telephone service," but that "[i]n the meantime, CMRS is a wholly interstate service and any interconnection to a CMRS provider, regardless of the source, is an interconnection governed by the FCC's interstate jurisdiction under Section 201 of the Communications Act."[2410]

1019. Some parties further argue that section 332(c)(1)(B) gives the Commission exclusive jurisdiction over LEC-to-CMRS interconnection rates.[2411] Cox argues that section

[2405] *Id.* at 44.

[2406] *Id.* at 39 n.77. *See also, e.g.*, Comcast comments in CC Docket No. 95-185 at 27; PageNet comments in CC Docket No. 95-185 at 37-38.

[2407] *Id.*

[2408] 47 U.S.C. § 332(c)(3)(A) (emphasis added).

[2409] 47 U.S.C. § 152(b) (emphasis added).

[2410] Cox comments in CC Docket No. 95-185 at 38-39.

[2411] *See, e.g.*, CTIA comments in Docket 95-185 at 62; Cox comments in CC Docket No. 95-185 at 44 n.78; Comcast comments in CC Docket No. 95-185 at 32.

332(c)(1)(B) expands the Commission's jurisdiction over CMRS by authorizing the Commission to order any common carrier, regardless of whether it is an intrastate or interstate carrier, to establish physical connections with any CMRS provider. Section 332(c)(1)(B) thus shows, according to Cox, "Congress' intent that the Commission be given full jurisdiction to regulate *all* aspects of CMRS, including interconnection to and from CMRS providers."[2412] Airtouch states that the Commission's section 201 jurisdiction is unaffected by Section 332(c)(1)(B) "except to the extent that the Commission is required to respond to [any CMRS provider's interconnection] request," and thus, section 332(c)(1)(B) does expand the Commission's section 201 authority, but only to the extent that LEC-CMRS interconnection - interstate and/or intrastate - is involved.[2413] CTIA contends that section 332(c)(3) must be read in a way that does not result in a one-sided regulatory scheme for LEC-to-CMRS interconnection and CMRS-to-LEC interconnection.[2414] Thus, according to CTIA, since section 332(c)(3) clearly preempts state regulation of interconnection rates charged *by* CMRS providers, it also preempts state regulation of interconnection rates charged *to* CMRS providers by LECs.[2415]

1020. Some parties contend that, because CMRS providers need interconnection to enter the market, all state regulation of interconnection affecting CMRS (including the intrastate rates charged by LECs) is entry regulation and therefore preempted under section 332(c)(3).[2416] Other commenters argue that section 253(e), which provides that "[n]othing in this section shall affect the application of section 332(c)(3) to commercial mobile service providers," demonstrates the Commission's exclusive jurisdiction over CMRS interconnection rates.[2417] CTIA argues that, "to apply Sections 251 and 252 to the LEC-CMRS relationship in place of Section 332, the Commission would effectively strip Section 332 of any meaning."[2418] Several parties also cite to the legislative history of both the 1993 Budget Act and the 1996 Act as support for their claims

---

[2412] Cox comments in CC Docket No. 95-185 at 39 n.78 (emphasis in original).

[2413] Airtouch comments at 6; *Ex Parte* letter from Kathleen Q. Abernathy, Airtouch, to William F. Caton, Acting Secretary, FCC, July 18, 1996, at 1-2.

[2414] CTIA comments in CC Docket No. 95-185 at 73.

[2415] *Id.*

[2416] Omnipoint comments in CC Docket No. 95-185 at 13 (disparate state regulation of interconnection would serve as a prohibited state barrier to entry under section 332(c)(3)); Celpage comments in CC Docket No. 95-185 at 11-12 (inconsistent state regulation of LEC-CMRS interconnection rates would create barriers to entry).

[2417] *See, e.g.*, PageNet comments at 29; *Ex Parte* letter in CC Docket No. 95-185 from Werner K. Hartenberger and Laura H. Phillips, Counsel for Cox Enterprises, Inc., to William F. Caton, Acting Secretary, FCC, February 28, 1996, at 8 (Cox Feb. 28 *Ex Parte*); *see also* Nextel reply at 5.

[2418] CTIA comments at 59-60.

that section 332 governs LEC-CMRS interconnection arrangements.[2419] Some commenters note that the 1996 Act did not explicitly repeal section 332, and state that implicit repeals are disfavored under principles of statutory construction.[2420] In addition, Cox argues that the exception in section 271(c) for cellular providers suggests that Congress considers cellular service to be in an entirely different competitive market from landline local exchange service, thus preserving the Commission's exclusive jurisdiction over LEC-CMRS interconnection granted by the 1993 Budget Act.[2421]

1021. Incumbent LECs and other parties, on the other hand, argue that section 251 controls interconnection between CMRS providers and incumbent LECs.[2422] Several of these parties contend that section 332 only governs the rates CMRS providers charge their end users, not the rates that LECs or CMRS providers charge other telecommunications carriers for interconnection.[2423] NYNEX claims that, while section 332(c)(1)(B) addresses the establishment of physical interconnection, it does not address particular compensation arrangements for interconnection between carriers, which Congress has now addressed in sections 251 and 252.[2424] Parties further note that the language in section 332(c)(1), stating that "this subparagraph shall not be construed as a limitation or expansion of the Commission's authority to order interconnection" expressly limits the Commission's authority to respond to a CMRS provider's request for interconnection and thus does not give the Commission jurisdiction over LEC-CMRS interconnection rates.[2425] BellSouth further argues that subjecting CMRS providers' charges for termination of LEC-originated calls to federal preemption would be inconsistent with Congress's

---

[2419] *See e.g.*, Cox comments at 43-44; *Ex Parte* letter in CC Docket No. 95-185 from Robert F. Roche, CTIA, to William F. Caton, Acting Secretary, FCC, February 28, 1996, at 1.

[2420] *See, e.g.*, Cox reply in CC Docket No. 95-185 at 69-70.

[2421] Cox Feb. 28 *Ex Parte* in CC Docket No. 95-185 at 8. Section 271(c)(1)(A) provides that, as one of the preconditions for BOC entry into the in-region, interLATA services market, a BOC must demonstrate the presence of a facilities-based competitor that provides telephone exchange service to residential and business subscribers. This section further provides that, "[f]or the purpose of this subparagraph, services provided pursuant to subpart K of part 22 of the Commission's regulations [cellular], . . . shall not be considered to be telephone exchange services." 47 U.S.C. § 271(c)(1)(A).

[2422] *See, e.g.*, USTA comments at 66-67; NYNEX comments at 23; PacTel comments at 83, reply at 38; Bell Atlantic/NYNEX Mobile comments at 7; BellSouth comments at 63; Pennsylvania Commission comments at 34.

[2423] *See, e.g.*, PacTel reply at 38; U S West comments at 61; *Ex Parte* letter in CC Docket No. 95-185 from Michael K. Kellogg, Counsel for Bell Atlantic and PacTel, to William F. Caton, Acting Secretary, FCC, February 26, 1996, at 4; BellSouth comments in CC Docket No. 95-185 at 34; Pennsylvania Commission comments at 34-35.

[2424] NYNEX reply at 13.

[2425] Ameritech comments in CC Docket No. 95-185 at 11; BellSouth comments in CC Docket No. 95-185 at 34-35.

determination in the 1996 Act that the terms and conditions of interconnection are to be decided by negotiation among LECs and telecommunications carriers, subject to the state review process.[2426]

3. Discussion

1022. Several parties in this proceeding argue that sections 251 and 252 provide the exclusive jurisdictional basis for regulation of LEC-CMRS interconnection rates.[2427] Other parties assert that sections 332 and 201 provide the exclusive jurisdictional basis for regulation of LEC-CMRS interconnection rates.[2428] Some parties have argued that jurisdiction resides concurrently under sections 251 and 252, on the one hand, and under sections 332 and 201 on the other.[2429]

1023. Sections 251, 252, 332 and 201 are designed to achieve the common goal of establishing interconnection and ensuring interconnection on terms and conditions that are just, reasonable, and fair. It is consistent with the broad authority of these provisions to hold that we may apply sections 251 and 252 to LEC-CMRS interconnection. By opting to proceed under sections 251 and 252, we are not finding that section 332 jurisdiction over interconnection has been repealed by implication, or rejecting it as an alternative basis for jurisdiction. We acknowledge that section 332 in tandem with section 201 is a basis for jurisdiction over LEC-CMRS interconnection; we simply decline to define the precise extent of that jurisdiction at this time.

1024. As a practical matter, sections 251 and 252 create a time-limited negotiation and arbitration process to ensure that interconnection agreements will be reached between incumbent LECs and telecommunications carriers, including CMRS providers. We expect that our establishment of pricing methodologies and default proxies which may be used as interim rates will help expedite the parties' negotiations and drive voluntary CMRS-LEC interconnection agreements. We also believe that sections 251 and 252 will foster regulatory parity in that these provisions establish a uniform regulatory scheme governing interconnection between incumbent LECs and all requesting carriers, including CMRS providers. Thus, we believe that sections 251 and 252 will facilitate consistent resolution of interconnection issues for CMRS providers and other carriers requesting interconnection.

[2426] BellSouth comments in CC Docket No. 95-185 at 35.

[2427] *See, e.g.*, USTA comments at 66-67; NYNEX comments at 23; PacTel comments at 83, reply at 38; Bell Atlantic/NYNEX Mobile comments at 7; BellSouth comments at 63; Pennsylvania Commission comments at 34.

[2428] *See, e.g.*, Cox comments in CC Docket No. 95-185 at 43-44; CTIA comments in CC Docket No. 95-185 at 62; Omnipoint comments at 12; Vanguard comments at 15.

[2429] *See, e.g.*, AT&T comments in CC Docket No. 95-185 at 28-30; AT&T comments at 42-44; *see also* PCIA comments in CC Docket No. 95-185 at 23-26; Century Cellunet comments in CC Docket No. 95-185 at 10-14.

1025. Although we are applying sections 251 and 252 to LEC-CMRS interconnection at this time, we preserve the option to revisit this determination in the future. We note that Section 332 generally precludes states from rate and entry regulation of CMRS providers, and thus, differentiates CMRS providers from other carriers.[2430] We also recognize that, based on the combined record in CC Docket No. 95-185 and CC Docket No. 96-68, there have been instances in which state commissions have treated CMRS providers in a discriminatory manner with respect to the terms and conditions of interconnection.[2431] Should the Commission determine that the regulatory scheme established by sections 251 and 252 does not sufficiently address the problems encountered by CMRS providers in obtaining interconnection on terms and conditions that are just, reasonable and nondiscriminatory, the Commission may revisit its determination not to invoke jurisdiction under section 332 to regulate LEC-CMRS interconnection rates.

1026. Our decision to proceed under section 251 as a basis for regulating LEC-CMRS interconnection rates should not be interpreted as undercutting our intent to enforce Section 332(c)(3), for example, where state regulation of interconnection rates might constitute regulation of CMRS entry. In such situations, state action might be precluded by either section 332 or section 253. Such circumstances would require a case-by-case evaluation. We note, however, that we are aware of numerous specific state requirements that may constitute CMRS entry or rate regulation preempted by section 332. For example, many states, such as California, require all telecommunications providers to certify that the public convenience and necessity will be served as a precondition to construction and operation of telecommunications services within the state.[2432] Some states, such as Alaska and Connecticut, also require CMRS providers to certify as service providers other than CMRS in order to obtain the same treatment afforded other telecommunications providers under state law.[2433] Hawaii and Louisiana, in addition to imposing a certification requirement, require CMRS providers and other telecommunications carriers to file

---

[2430] In passing section 332 in 1993, Congress stated that it intended to "foster the growth and development of mobile services that, by their nature, operate without regard to state lines as an integral part of the national telecommunications infrastructure." H.R. Report No. 103-11, 103d. Cong., 1st Sess. 260 (1993).

[2431] *See supra*, Section VII.D.

[2432] CAL. PUBLIC UTILITIES CODE Sections 1001,1005 (West 1995); ALASKA STAT. Section 42.05221 (1995); CONN. GEN. STAT. Section 16-247g (1995); HAW. REV. STAT. Section 269-7.5 (1995); NEB. REV. STAT. Section 86-805 (1995); N.M. STAT. ANN. Section 63-9B-4 (Michie 1996).

[2433] *See In the Matter of Motion for a Declaratory Ruling Concerning Preemption of Alaska Call Routing and Interexchange Certification Regulation as Applies to Cellular Carriers*, File No. WTB/POL 95-2, *Motion for a Declaratory Ruling*, Alaska-3 Cellular d/b/a CellularOne, p.5, para. 11 (filed Sept. 22, 1995); *Decision, Investigation Into Wireless Mutual Compensation Plans*, State of Connecticut, Department of Public Utility control, at 15 (Connecticut Commission Sept. 22, 1995).

tariffs with the state commission.[2434] We will not permit entry regulation through the exercise of states' sections 251/252 authority or otherwise. In this regard, we note that states may not impose on CMRS carriers rate and entry regulation as a pre-condition to participation in interconnection agreements that may be negotiated and arbitrated pursuant to sections 251 and 252. We further note that the Commission is reviewing filings made pursuant to section 253 alleging that particular states or local governments have requirements that constitute entry barriers, in violation of section 253. We will continue to review any allegations on an ongoing basis, including any claims that states or local governments are regulating entry or imposing requirements on CMRS providers that constitute barriers to market entry.

[2434] HAW. REV. STAT. Section 6-80-29 (1996); *see In re Regulations for Competition in the Local Telecommunications Market*, General Order, Louisiana Public Service Commission, §§ 301, 401 (Louisiana Commission March 15, 1996).

XI. OBLIGATIONS IMPOSED ON LECS BY SECTION 251(b)[2435]

A. Reciprocal Compensation for Transport and Termination of Telecommunications

1. Statutory Language

1027. Section 251(b)(5) provides that all LECs, including incumbent LECs, have the duty to "establish reciprocal compensation arrangements for the transport and termination of telecommunications."[2436] Section 252(d)(2) states that, for the purpose of compliance by an incumbent LEC with section 251(b)(5), a state commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless such terms and conditions both: (1) provide for the "mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier," and (2) "determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls."[2437] That subsection further provides that the foregoing language shall not be construed "to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill and keep arrangements),"[2438] or to authorize the Commission or any state to "engage in any rate regulation proceeding to establish with particularity the additional costs of transporting or terminating calls, or require carriers to maintain records with respect to the additional costs of such calls."[2439] The legislative history indicates that "mutual and reciprocal recovery of costs . . . may include a range of compensation schemes, such as in-kind exchange of traffic without cash payment (known as bill-and-keep arrangements)."[2440]

[2435] Additional obligations imposed by section 251(b) are addressed in a separate order. *See* NPRM at paras. 202-219.

[2436] 47 U.S.C. § 251(b)(5).

[2437] 47 U.S.C. § 252(d)(2)(A).

[2438] *Id.* at § 252(d)(2)(B)(i).

[2439] *Id.* at § 252(d)(2)(B)(ii).

[2440] Joint Explanatory Statement at 7.

2. Definition of Transport and Termination of Telecommunications

a. Background

1028. In the NPRM, we sought comment on whether "transport and termination of telecommunications" under section 251(b)(5) is limited to certain types of traffic.[2441] We noted that the statutory provision appears to encompass telecommunications traffic that originates on the network of one LEC and terminates on the network of a competing provider in the same local service area as well as traffic passing between LECs and CMRS providers.[2442] We sought comment on whether section 251(b)(5) also encompasses telecommunications traffic passing between neighboring LECs that do not compete with one another.[2443] We also observed in the NPRM that section 252(d)(2) is entitled "Charges for Transport and Termination of Traffic," and it could be interpreted to permit separate charges for these two components of reciprocal compensation.[2444] We sought comment on this issue.

b. Comments

1029. Numerous commenters contend that section 251(b)(5) applies to traffic originating on the network of one LEC and terminating on the network of another LEC, including both the traffic exchanged between competing LECs and traffic exchanged between neighboring LECs that do not compete with one another.[2445] The Oregon Commission points out that neither section 251 nor any other provision of the Act excludes the transport and termination of telecommunications traffic passing between neighboring LECs that do not compete with one another.[2446] Several incumbent LECs, however, contend that the requirements imposed on LECs by section 251(b), including reciprocal compensation for transport and termination of traffic, make no sense except in the context of LECs offering service in the same geographic area, because these requirements are relevant only to the competitive relationship between such carriers.[2447] In addition, several commenters contend that parties and states will need to determine the local service area within

[2441] NPRM at para. 231.

[2442] NPRM at para. 230.

[2443] *Id.*

[2444] NPRM at para. 231.

[2445] *See, e.g.*, Ohio Commission comments at 68-69; MFS comments at 76; Time Warner comments at 85-86.

[2446] Oregon Commission comments at 35.

[2447] PacTel comments at 95-96; NYNEX comments at 85; *see also* Florida Commission comments at 38-39.

which the compensation right applies.[2448] RTC asserts that elimination of multicompany existing extended area service (EAS)[2449] would cause great rate disruption around the country.[2450]

1030. A wide range of commenters also contend that reciprocal compensation should apply to arrangements between CMRS providers and LECs.[2451] Numerous commenters in the *LEC-CMRS Interconnection* proceeding have argued that CMRS providers do not receive reciprocal compensation for the transport and termination of traffic from incumbent LECs,[2452] and in some cases incumbent LECs require CMRS providers to compensate the LEC for wireline-originated traffic terminated on their wireless systems.[2453] PageNet, however, contends that section 251 is not directly applicable to interconnection arrangements between incumbent LECs and CMRS providers.[2454] Instead, it argues that incumbent LEC to CMRS interconnection is governed by section 332 of the 1934 Act.[2455] Several wireless providers argue that neither CMRS nor traditional paging service fits the Act's definition of a local exchange service and, therefore, these services are exempt from section 251(b) requirements.[2456] Paging companies commented in the *LEC-CMRS Interconnection* proceeding that, despite the fact that paging companies must terminate incoming incumbent LEC calls, the paging companies pay the LECs for call

[2448] *See* GTE comments at 54; Continental comments at 12-13 (asserting that a new entrant should not be required to pay toll access charges to terminate its customers within its local calling area); NCTA reply at 17 (arguing that the Commission should reject incumbent LECs' arguments that reciprocal compensation arrangements between incumbent LECs and competitive LECs are only applicable to the termination of incumbent LEC-defined local traffic). *But see* PacTel reply at 48 (arguing that transport and termination does not extend to all intraLATA calls because such a requirement would read access charges out of the Act).

[2449] EAS is considered an interexchange service between non-competing LECs.

[2450] RTC reply at v; *see also* GVNW comments at 41 (Historical interconnection arrangements between neighboring incumbent LECs should not be used as a basis for determining appropriate compensation between carriers competing in the same service areas under a statutory mandate to base compensation on the cost of terminating a call).

[2451] *See, e.g.*, Ohio Commission comments at 68-69; NYNEX comments at 85; ProNet comments at 11-12.

[2452] *See, e.g.*, RCC comments in CC Docket No. 95-185 at 5; 360 Degrees comments in CC Docket No. 95-185 at 3; Western Wireless comments in CC Docket No. 95-185 at 13; Omnipoint reply in CC Docket No. 95-185 at 3-7.

[2453] *See, e.g.*, CMT Partners comments in CC Docket No. 95-185 at 4; Century Cellunet comments in CC Docket No. 95-185 at 4; Nextel Communications comments in CC Docket No. 95-185 at 5; Centennial Cellular Corp. comments in CC Docket No. 95-185 at 9.

[2454] PageNet comments at 12-14.

[2455] *Id.; see also* PCIA comments at 1-12; Mobilemedia comments at 5-12; Arch comments at 17.

[2456] *See, e.g.*, ProNet comments at 7; Arch comments at 17; BANM comments at 2.

origination, rather than receive compensation for call termination.[2457] They also contend that paging companies should be permitted to charge reasonable call termination fees to the LECs.[2458]

1031. Incumbent LECs as well as other commenters contend that transport and termination should be treated as two distinct functions.[2459] They generally define transport as carrying traffic between switches within a network, while termination is characterized as delivering traffic through the last end-office switch to the end user.[2460] The Texas Public Utility Counsel argues that, to the extent that transport functions and call termination functions have different cost structures, the Act would mandate a two-part pricing structure.[2461] U S West notes that, while there is no natural substitute for termination, transport is interoffice and would generally be interchangeable with similar network elements or tariffed access services.[2462] In addition, Citizens Utilities contends that, depending on the location of the physical interconnection point between two carriers and each carrier's network design, the terminating carrier may or may not perform any transport service in the call delivery process.[2463] Therefore, it argues that the transport function logically should be unbundled from the termination function.[2464] USTA and potential new entrants, however, argue that transport and termination describe a single function, the costs of which should be recovered from a single charge for purposes of reciprocal compensation.[2465] GST believes that subdivision of transport and termination as a means of applying asymmetrical rate structures conflicts with the statute's command of reciprocal compensation, and gives LECs incentives to tilt the balance of payment

[2457] *See* PageNet reply in CC Docket No. 95-185 at 5.

[2458] *See, e.g.*, PageNet comments in CC Docket No. 95-185 at 25-29.

[2459] *See, e.g.*, U S West comments at 69; PacTel comments at 97; GTE comments at 18; Florida Commission comments at 39.

[2460] *See, e.g.*, U S West comments at 69; PacTel comments at 97; GTE comments at 18; BellSouth comments at 71.

[2461] Texas Public Utility Counsel comments at 49-50; *see also* Arch comments at 17-18; Florida Commission comments at 39.

[2462] U S West comments at 69. Similarly, CFA/CU argues that the availability of termination for new entrants is a monopoly enjoyed by the incumbent LEC as a legacy of its historic monopoly. CFA/CU comments at 52-53; *see also* MFS reply at 17.

[2463] Citizens Utilities comments at 29; *see also* BellSouth comments at 71.

[2464] *Id.*

[2465] USTA comments at 80; *see also* GST comments at 35-38; MFS comments at 76-77; Time Warner comments at 86-88; TCI comments at 27-28.

through their network design decisions.[2466]

1032. In addition, Sprint contends that section 251(b)(5) arguably applies to transport and termination of toll traffic as well as local traffic.[2467] Sprint contends, however, that in the context of section 252(d)(2), which establishes a pricing rule for reciprocal compensation where one of the carriers is an incumbent LEC, it appears that Congress intended to confine to local traffic the obligation of transport and termination.[2468] Several other commenters also maintain that toll traffic should remain subject to access charges and not section 251(b)(5) obligations, at least until access charge reform can be implemented.[2469] RTC argues that Congress made it clear that it did not intend the Act to change the access charge regime.[2470] Frontier, however, contends that Sprint's reliance on the wording of section 252(d)(2) as limiting the scope of section 251(b)(5) is simply misguided.[2471] Frontier argues that, at best, section 252(d)(2)'s silence regarding the pricing by an incumbent LEC simply meant that Congress did not intend to constrain the Commission decisions in the pricing of transport and termination by a non-incumbent LEC under section 252(d)(2).[2472] In sum, Frontier contends that the general principles of mutual and reciprocal compensation under section 251(b)(5) would apply to all traffic, while section 252(d)(2) applies to incumbent LEC pricing of mutual compensation involving any additional costs of transport and termination.[2473]

c. Discussion

(1) Distinction between "Transport and Termination" and Access

1033. We recognize that transport and termination of traffic, whether it originates locally or from a distant exchange, involves the same network functions. Ultimately, we believe that the rates that local carriers impose for the transport and termination of local traffic and for the transport and termination of long distance traffic should converge. We conclude, however, as a

[2466] GST comments at 35-38.

[2467] Sprint comments at 76.

[2468] *Id.* at 76-77.

[2469] *See, e.g.*, Alabama Commission comments at 32-33; PacTel comments at 95-96, 98, reply at 48; MFS comments at 76.

[2470] RTC reply at 9.

[2471] Frontier reply at 19.

[2472] *Id.*

[2473] *Id.*

legal matter, that transport and termination of local traffic are different services than access service for long distance telecommunications. Transport and termination of local traffic for purposes of reciprocal compensation are governed by sections 251(b)(5) and 252(d)(2), while access charges for interstate long-distance traffic are governed by sections 201 and 202 of the Act. The Act preserves the legal distinctions between charges for transport and termination of local traffic and interstate and intrastate charges for terminating long-distance traffic.

1034. We conclude that section 251(b)(5) reciprocal compensation obligations should apply only to traffic that originates and terminates within a local area, as defined in the following paragraph. We disagree with Frontier's contention that section 251(b)(5) entitles an IXC to receive reciprocal compensation from a LEC when a long-distance call is passed from the LEC serving the caller to the IXC. Access charges were developed to address a situation in which three carriers -- typically, the originating LEC, the IXC, and the terminating LEC -- collaborate to complete a long-distance call. As a general matter, in the access charge regime, the long-distance caller pays long-distance charges to the IXC, and the IXC must pay both LECs for originating and terminating access service.[2474] By contrast, reciprocal compensation for transport and termination of calls is intended for a situation in which two carriers collaborate to complete a local call. In this case, the local caller pays charges to the originating carrier, and the originating carrier must compensate the terminating carrier for completing the call. This reading of the statute is confirmed by section 252(d)(2)(A)(i), which establishes the pricing standards for section 251(b)(5). Section 251(d)(2)(A)(i) provides for "recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier."[2475] We note that our conclusion that long distance traffic is not subject to the transport and termination provisions of section 251 does not in any way disrupt the ability of IXCs to terminate their interstate long-distance traffic on LEC networks. Pursuant to section 251(g), LECs must continue to offer tariffed interstate access services just as they did prior to enactment of the 1996 Act. We find that the reciprocal compensation provisions of section 251(b)(5) for transport and termination of traffic do not apply to the transport or termination of interstate or intrastate interexchange traffic.

1035. With the exception of traffic to or from a CMRS network, state commissions have the authority to determine what geographic areas should be considered "local areas" for the purpose of applying reciprocal compensation obligations under section 251(b)(5), consistent with the state commissions' historical practice of defining local service areas for wireline LECs. Traffic originating or terminating outside of the applicable local area would be subject to interstate and intrastate access charges. We expect the states to determine whether intrastate transport and termination of traffic between competing LECs, where a portion of their local

[2474] In addition, both the caller and the party receiving the call pay a flat-rated interstate access charge -- the end-user common line charge -- to the respective incumbent LEC to whose network each of these parties is connected.

[2475] 47 U.S.C. § 252(d)(2)(A)(i).

service areas are not the same, should be governed by section 251(b)(5)'s reciprocal compensation obligations or whether intrastate access charges should apply to the portions of their local service areas that are different. This approach is consistent with a recently negotiated interconnection agreement between Ameritech and ICG that restricted reciprocal compensation arrangements to the local traffic area as defined by the state commission.[2476] Continental Cablevision, in an *ex parte* letter, states that many incumbent LECs offer optional expanded local area calling plans, in which customers may pay an additional flat rate charge for calls within a wider area than that deemed as local, but that terminating intrastate access charges typically apply to calls that originate from competing carriers in the same wider area.[2477] Continental Cablevision argues that local transport and termination rates should apply to these calls. We lack sufficient record information to address the issue of expanded local area calling plans; we expect that this issue will be considered, in the first instance, by state commissions. In addition, we expect the states to decide whether section 251(b)(5) reciprocal compensation provisions apply to the exchange of traffic between incumbent LECs that serve adjacent service areas.

1036. On the other hand, in light of this Commission's exclusive authority to define the authorized license areas of wireless carriers, we will define the local service area for calls to or from a CMRS network for the purposes of applying reciprocal compensation obligations under section 251(b)(5).[2478] Different types of wireless carriers have different FCC-authorized licensed territories, the largest of which is the "Major Trading Area" (MTA).[2479] Because wireless licensed territories are federally authorized, and vary in size, we conclude that the largest FCC-authorized wireless license territory (*i.e.*, MTA) serves as the most appropriate definition for local service area for CMRS traffic for purposes of reciprocal compensation under section 251(b)(5) as it avoids creating artificial distinctions between CMRS providers. Accordingly, traffic to or from a CMRS network that originates and terminates within the same MTA is subject to transport and termination rates under section 251(b)(5), rather than interstate and intrastate access charges.

1037. We conclude that section 251(b)(5) obligations apply to all LECs in the same state-defined local exchange service areas, including neighboring incumbent LECs that fit within this description. Contrary to the arguments of NYNEX and Pacific Telesis, neither the plain language of the Act nor its legislative history limits this subsection to the transport and termination of telecommunications traffic between new entrants and incumbent LECs. In addition, applying

[2476] *See* letter from Albert H. Kramer, Dickstein, Shapiro, Morin & Oshinsky LLP to John Nakahata, Senior Legal Advisor to the Chairman, FCC, July 11, 1996.

[2477] Letter from Brenda L. Fox, Vice President, Federal Relations, Continental Cablevision, to Robert Pepper, Chief, Office of Plans and Policy, FCC, July 22, 1996, attached to Letter from Donna N. Lampert, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., to William F. Caton, Acting Secretary, FCC, July 22, 1996.

[2478] *See also infra*, Section XI.A.c.3.

[2479] *See* Rand McNally, Inc., *1992 Commercial Atlas & Marketing Guide* 38-39 (1992).

section 251(b)(5) obligations to neighboring incumbent LECs in the same local exchange area is consistent with our decision that all interconnection agreements, including agreements between neighboring LECs, must be submitted to state commissions for approval pursuant to section 252(e).[2480]

1038. Under section 252, neighboring states may establish different rate levels for transport and termination of traffic.[2481] In cases in which territory in multiple states is included in a single local service area, and a local call from one carrier to another crosses state lines, we conclude that the applicable rate for any particular call should be that established by the state in which the call terminates. This provides an administratively convenient rule, and termination of the call typically occurs in the same state where the terminating carrier's end office switch is located and where the cost of terminating the call is incurred.

(2) Distinction between "Transport" and "Termination"

1039. We conclude that transport and termination should be treated as two distinct functions. We define "transport," for purposes of section 251(b)(5), as the transmission of terminating traffic that is subject to section 251(b)(5) from the interconnection point between the two carriers to the terminating carrier's end office switch that directly serves the called party (or equivalent facility provided by a non-incumbent carrier). Many alternative arrangements exist for the provision of transport between the two networks. These arrangements include: dedicated circuits provided either by the incumbent LEC, the other local service provider, separately by each, or jointly by both; facilities provided by alternative carriers; unbundled network elements provided by incumbent LECs; or similar network functions currently offered by incumbent LECs on a tariffed basis. Charges for transport subject to section 251(b)(5) should reflect the forward-looking cost of the particular provisioning method.

1040. We define "termination," for purposes of section 251(b)(5), as the switching of traffic that is subject to section 251(b)(5) at the terminating carrier's end office switch (or equivalent facility) and delivery of that traffic from that switch to the called party's premises. In contrast to transport, for which some alternatives exist, alternatives for termination are not likely to exist in the near term. A carrier or provider typically has no other mechanism for delivering traffic to a called party served by another carrier except by having that called party's carrier terminate the call. In addition, forward-looking costs are calculated differently for the transport of traffic and the termination of traffic, as discussed above in the unbundled elements section.[2482]

[2480] *See supra*, Section III.D.

[2481] We discuss the methodology states should follow in establishing transport and termination rates *infra*, Section XI.A.3.c.(3).

[2482] *See infra*, Section VII.B.2.

As such, we conclude that we need to treat transport and termination as separate functions -- each with its own cost. With respect to GST's contention that separate charges for transport and termination of traffic will allow incumbent LECs to "game" the system through network design decisions, we conclude in the interconnection section above that interconnecting carriers may interconnect at any technically feasible point.[2483] We find that this sufficiently limits LECs' ability to disadvantage interconnecting parties through their network design decisions.

(3) CMRS-Related Issues

1041. Section 251(b)(5) obligates LECs to establish reciprocal compensation arrangements for the transport and termination of telecommunications traffic. Although section 252(b)(5) does not explicitly state to whom the LEC's obligation runs, we find that LECs have a duty to establish reciprocal compensation arrangements with respect to local traffic originated by or terminating to any telecommunications carriers. CMRS providers are telecommunications carriers and, thus, LECs' reciprocal compensation obligations under section 251(b)(5) apply to all local traffic transmitted between LECs and CMRS providers.

1042. We conclude that, pursuant to section 251(b)(5), a LEC may not charge a CMRS provider or other carrier for terminating LEC-originated traffic. Section 251(b)(5) specifies that LECs and interconnecting carriers shall compensate one another for termination of traffic on a reciprocal basis. This section does not address charges payable to a carrier that originates traffic. We therefore conclude that section 251(b)(5) prohibits charges such as those some incumbent LECs currently impose on CMRS providers for LEC-originated traffic. As of the effective date of this order, a LEC must cease charging a CMRS provider or other carrier for terminating LEC-originated traffic and must provide that traffic to the CMRS provider or other carrier without charge.

1043. As noted above, CMRS providers' license areas are established under federal rules, and in many cases are larger than the local exchange service areas that state commissions have established for incumbent LECs' local service areas.[2484] We reiterate that traffic between an incumbent LEC and a CMRS network that originates and terminates within the same MTA (defined based on the parties' locations at the beginning of the call) is subject to transport and termination rates under section 251(b)(5), rather than interstate or intrastate access charges. Under our existing practice, most traffic between LECs and CMRS providers is not subject to interstate access charges unless it is carried by an IXC, with the exception of certain interstate interexchange service provided by CMRS carriers, such as some "roaming" traffic that transits

---

[2483] *See supra*, Section IV.F..

[2484] *See* 47 C.F.R. §§ 22.911, 24.202; *see also* PCIA comments in CC Docket No. 95-185 at 21-22; Letter from Leonard J. Kennedy, on behalf of Comcast Cellular Communications, to William Caton, Acting Secretary, FCC, July 25, 1996.

incumbent LECs' switching facilities, which is subject to interstate access charges.[2485] Based on our authority under section 251(g) to preserve the current interstate access charge regime, we conclude that the new transport and termination rules should be applied to LECs and CMRS providers so that CMRS providers continue not to pay interstate access charges for traffic that currently is not subject to such charges, and are assessed such charges for traffic that is currently subject to interstate access charges.[2486]

1044. CMRS customers may travel from location to location during the course of a single call, which could make it difficult to determine the applicable transport and termination rate or access charge.[2487] We recognize that, using current technology, it may be difficult for CMRS providers to determine, in real time, which cell site a mobile customer is connected to, let alone the customer's specific geographic location.[2488] This could complicate the computation of traffic flows and the applicability of transport and termination rates, given that in certain cases, the geographic locations of the calling party and the called party determine whether a particular call should be compensated under transport and termination rates established by one state or another, or under interstate or intrastate access charges. We conclude, however, that it is not necessary for incumbent LECs and CMRS providers to be able to ascertain geographic locations when determining the rating for any particular call at the moment the call is connected. We conclude that parties may calculate overall compensation amounts by extrapolating from traffic studies and samples. For administrative convenience, the location of the initial cell site when a call begins shall be used as the determinant of the geographic location of the mobile customer. As an

[2485] "[S]ome cellular carriers provide their customers with a service whereby a call to a subscriber's local cellular number will be routed to them over interstate facilities when the customer is "roaming" in a cellular system in another state. In this case, the cellular carrier is providing not local exchange service but interstate, interexchange service. In this and other situations where a cellular company is offering interstate, interexchange service, the local telephone company providing interconnection is providing exchange access to an interexchange carrier and may expect to be paid the appropriate access charge . . . . Therefore, to the extent that a cellular operator does provide interexchange service through switching facilities provided by a telephone company, its obligation to pay carrier's carrier [*i.e.*, access] charges is defined by § 69.5(b) of our rules." *The Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carrier Services*, 59 RR 2d 1275, 1284-85 n.3 (1986). *See also Implementation of Sections 3(n) and 332 of the Communications Act, Regulatory Treatment of Mobile Services*, GN Docket No. 93-252, Second Report and Order, 9 FCC Rcd 1411, 1497-98 (1994) (concluding that there should be no distinction between incumbent LECs' interconnection arrangements with cellular carriers and those with other CMRS providers).

[2486] *See also, supra*, XI.A.2.c.(1).

[2487] In the *LEC-CMRS Interconnection NPRM*, we observed that a significant amount of LEC-CMRS traffic crosses state lines, because CMRS service areas often cross state lines and CMRS customers are mobile. *LEC CMRS Interconnection NPRM* at para. 112.

[2488] *Revision of the Commission's Rules to Ensure Compatibility with Enhanced 911 Emergency Calling Systems*, CC Docket No. 94-102, RM-8143, Report and Order and Further Notice of Proposed Rulemaking, FCC 96-264 at paras. 8-9 (adopted June 12, 1996, released July 26, 1996).

alternative, LECs and CMRS providers can use the point of interconnection between the two carriers at the beginning of the call to determine the location of the mobile caller or called party.

1045. As discussed above, pursuant to section 251(b)(5) of the Act, all local exchange carriers, including small incumbent LECs and small entities offering competitive local exchange services, have a duty to establish reciprocal compensation arrangements for the transport and termination of local exchange service. CMRS providers, including small entities, and LECs, including small incumbent LECs and small entity competitive LECs, will receive reciprocal compensation for terminating certain traffic that originates on the networks of other carriers, and will pay such compensation for certain traffic that they transmit and terminate to other carriers. We believe that these arrangements should benefit all carriers, including small incumbent LECs and small entities, because it will facilitate competitive entry into new markets while ensuring reasonable compensation for the additional costs incurred in terminating traffic that originates on other carriers' networks. We also recognize that, to implement transport and termination pursuant to section 251(b)(5), carriers, including small incumbent LECs and small entities, may be required to measure the exchange of traffic, but we believe that the cost of such measurement to these carriers is likely to be substantially outweighed by the benefits of these arrangements.[2489]

3. Pricing Methodology

a. Background

1046. In the NPRM, we sought comment on how to interpret section 252(d)(2) of the Act.[2490] Specifically, we asked if we should establish a generic pricing methodology or impose a ceiling to guide the states in setting the charge for the transport and termination of traffic. We also asked whether such a generic pricing methodology or ceiling should be established using the same principles we adopt for interconnection and unbundled elements.[2491] Additionally, we sought comment on the use of an interim and transitional pricing mechanism that would address concerns about unequal bargaining power in negotiations.[2492]

[2489] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2490] NPRM at para. 234.

[2491] NPRM at para. 234.

[2492] NPRM at para. 244.

b. Comments

1047. Time Warner argues that call termination is an essential element in completing calls and that this last "bottleneck" should be governed by a lower cost standard than elements that are based on a competitor's "make or buy decisions."[2493] MCI contends that the level of compensation for transport and termination should be determined by calculating the TSLRIC incurred by the incumbent in providing the network elements necessary to terminate the local calls originating on the networks of its competitors, and converting that cost to a per-minute rate.[2494] Cox asserts that section 252(d)(2) requires that competing carriers have mutual obligations to terminate traffic that originates on competitors' networks, and that this obligation requires that the rate for transport and termination be less than the rate charged for unbundled elements.[2495] Cox advocates the use of LRIC, as opposed to TSLRIC, methodology to set transport and termination rates because LRIC recognizes only the cost of capital expenditures to provide the additional terminations and transport required by a competitive local service provider, including maintenance and depreciation of those facilities, without any allocation of overhead.[2496]

1048. BellSouth argues that the recovery of transport and termination costs should include joint and common costs and that no LEC can charge rates for transport and termination in excess of access charges because potential customers would simply choose arrangements under the latter.[2497] The Western Alliance asserts that rates for the transport and termination of traffic must allow rural LECs to recover the incremental cost of local access, a reasonable apportionment of joint and common costs, and any lost contribution to basic, local service rates represented by the interconnecting carriers' service.[2498] The Western Alliance argues that recovery of lost contribution is especially important for smaller LECs because they are unlikely to have alternative sources from which to support basic service rates.[2499] USTA argues rates should be based on existing prices (*i.e.* access charges) because this would not require small and mid-sized incumbent

---

[2493] Time Warner comments at 50. "Make or buy decision" is Time Warner's term for deciding between providing services through its own facilities or through resale and/or purchasing unbundled elements.

[2494] MCI comments at 48-49; *see also* NCTA comments at 47-50; Comcast comments at 22; Competition Policy Institute reply at 15.

[2495] Cox comments at 34; *see also* Sprint Spectrum/APC comments at 8-9.

[2496] Cox comments at 25-26; *see also* GST comments at 38-40; MFS comments at 80-81. We note above that TSLRIC is one instance of LRIC where the increment chosen is the provision of the entire service.

[2497] BellSouth comments at 70-72; *see also* MECA comments at 5; and Mass. Commission comments at 8-9.

[2498] Western Alliance comments at 5.

[2499] *Id. at* 7 n. 14.

LECs to conduct cost studies that could bog down the interconnection negotiation process.[2500] GTE claims that the "additional costs incurred" language undermines the contention that cost studies must assume the most efficient technology available because costs are incurred using actual network technology, not a theoretical network.[2501]

1049. The Illinois Commission asserts that the two different pricing standards in sections 252(d)(1)(A)(i) and 252(d)(2)(A)(ii) are not mutually exclusive and the text of the two provisions does not prohibit the states from using identical pricing standards for the two categories of service. The Illinois Commission notes that there is some substitutability between unbundled network elements and incumbent LEC transport and termination of a competitor's traffic. Consequently, the Illinois Commission contends that two widely disparate policies for the pricing of these services may have potentially distorting effects.[2502] The Illinois Commission further argues that section 252(d)(2)(B)(ii) does not prohibit rate regulation proceedings to establish transport and termination costs and does not bar a state from requiring carriers to maintain records regarding transport and termination costs, if authority exists independently of the 1996 Act.[2503] GST argues that section 252(d)(2)(B)(ii)'s prohibition against use of cost studies to set transport and termination rates suggests Congress intended for compensation prices to be set on the basis of economically relevant costs, not on the basis of artificial regulatory mechanisms, such as separations, revenue requirements, or a carrier's embedded investment.[2504]

1050. The Ohio Commission asserts that states should establish a price ceiling for transport and termination of local traffic on the basis of an imputation test. The Ohio Commission argues that the ceiling price for transport and termination of local traffic should be such that it allows the incumbent LEC to pass an imputation test for local traffic in the aggregate (*i.e.*, flat-rated, message, and measured local residence and business traffic) at the end user rate levels.[2505] Similarly, MFS suggests that the Commission adopt a rate equal to one half of the retail rate because, as a general rule, call origination and billing can be presumed to be equal to the cost of transport and termination.[2506] Jones Intercable contends that the Commission should

---

[2500] USTA comments at 54-55.

[2501] GTE reply at 30; *see also* PacTel reply at 45-46.

[2502] Illinois Commission comments at 76-77; *see also* California Commission comments at 42; ACSI comments at 10-11; Ohio Commission comments at 70-71; Texas Public Utility Counsel comments at 1, 50; Lincoln Tel. comments at 20; Citizens Utilities comments at 32-33.

[2503] Illinois Commission comments at 78; *see also* California Commission comments at 43-44.

[2504] GST comments at 39.

[2505] Ohio Commission comments at 71-72, 78-79.

[2506] MFS comments at 87.

establish a presumption that all LECs can offer traffic termination at a rate that is no higher than the lowest rate that has been agreed to (or imposed through arbitration) for such traffic termination by *any* LEC. Jones Intercable adds that such a rule is immensely practical because it relieves competitors of the need to fight the same battle in all fifty states.[2507]

1051. The California Commission asserts that ceilings for transport and termination present problems because a ceiling based on, for example, switched access rates would have to take into account widely varying rates among states. The California Commission is also opposed to price floors for call termination because they may conflict with bill-and-keep arrangements.[2508] GST opposes the use of access charges to set reciprocal transport and termination rates because access charges are fundamentally based on rates of return.[2509] TCI argues that there has been sufficient evidence compiled in state proceedings for the Commission to determine the price ceiling based on existing TSLRIC studies and suggests a price ceiling of 0.4 cents per minute of use.[2510] The Illinois and Maryland commissions have adopted rates for the termination of traffic based on incremental cost studies. The Illinois Commission has adopted a rate equal to 0.5 cents ($0.005) per minute of use for termination from the end office switch. Maryland has adopted a rate equal to 0.3 cents ($0.003) per minute of use for termination from the end office switch. Both commissions adopted slightly higher rates for transport and termination via tandem switches equal to 0.5 cents ($0.005) in Maryland and 0.75 cents ($0.0075) in Illinois.[2511]

1052. Most commenters support the requirement that dedicated transport services be priced on a flat-rated basis.[2512] For example, the Ohio Commission asserts that all LECs should offer a reciprocal compensation structure that consists of both flat-rated elements and usage-sensitive elements, in order to satisfy the requirement that the rate structure reflect the way in which costs are incurred by the providing LEC.[2513] According to Lincoln Telephone, the connection between an incumbent LEC's central office and an interconnector's network should be

---

[2507] Jones Intercable comments at 29-30.

[2508] California Commission comments at 43; *see also* Florida Commission comments at 40 (setting charges for the transport and termination of local exchange traffic should be left up to the states because of the unique geographical and demographic characteristics of each state).

[2509] GST comments at 39-40.

[2510] TCI comments at 40-43.

[2511] These cost studies, and others, are discussed in greater detail in *supra.*, Section VII.C.3.

[2512] *See, e.g.*, USTA comments at 80; Time Warner comments at 91-92; NEXTLINK comments at 34-35; Mass. Attorney General comments at 16-17, 22-23; CFA/CU comments at 51; Washington Commission comments at 3; Sprint comments at 79.

[2513] Ohio Commission comments at 68-69.

priced as a flat-rated unbundled network element.[2514] The Massachusetts Attorney General recommends that termination charges be flat-rated and capacity-based.[2515] This capacity-based, flat-rated reciprocal compensation charge would be based on port charges, measured at the peak busy hour of the month, to determine the relative traffic flow over the respective networks. The Massachusetts Attorney General further argues that, in a highly competitive market where services and prices would be continuously changing, rates charged by minutes of use will distort marketing and investment decisions away from the efficient path.[2516] Cox contends capacity-cost approaches should be used as the basic standard for setting transport and termination rates because costs are incurred in that manner.[2517] Additionally, Cox argues a capacity-cost approach addresses peak-load pricing problems because an interconnecting carrier is effectively reserving and paying for a slice of capacity on a full-time basis.[2518] Other carriers support a per-minute charge for transport and termination.[2519] In addition to a rate based on minutes of use, the Maryland Commission does not oppose flat-rated options for termination of traffic based on capacity costs measured at peak hours.[2520] BellSouth adds that usage-based charging is relatively more favorable to smaller competitors and facilities-based charging is relatively more favorable to larger competitors.[2521]

1053. Numerous new entrants and state commissions support the use of an interim pricing mechanism and support the use of bill and keep as such an interim measure.[2522] In the *LEC-CMRS Interconnection* proceeding, most CMRS providers argue in support of an interim pricing approach for transport and termination arrangements while long-term solutions are pursued.[2523]

[2514] Lincoln Tel. comments at 22.

[2515] Mass. Attorney General comments at 15-16.

[2516] Mass. Attorney General comments at 16-17; *see also* CFA/CU comments at 55-56; Washington Commission comments at 3.

[2517] Cox comments at Exhibit 3 (Bargaining Incentives and Interconnection), p. 7.

[2518] *Id.*

[2519] *See, e.g.*, MCI comments at 48-49; SBC comments at 50 n.91.

[2520] Maryland Commission comments at Attachment (Maryland Commission Order No. 72348), p. 33.

[2521] BellSouth comments at Attachment (Interconnection and Economic Efficiency), p. 11.

[2522] *See, e.g.*, GST comments at 34-35; AT&T comment at 69; Cox comments at 27-28, 38; Sprint comments at 87; Jones Intercable comments at 28-29; Citizens Utilities comments at 30; Telecommunication Resellers Ass'n comments at 54-55.

[2523] *See, e.g.*, AirTouch comments in CC Docket No. 95-185 at 38-39.

Cincinnati Bell asserts that the suggestion that an interim mechanism may be necessary to offset bargaining power of incumbent LECs incorrectly assumes that the incumbent LEC will always have greater bargaining power in the process of negotiations.[2524] Cincinnati Bell argues that, to the contrary, small and mid-size LECs will be at a disadvantage when they negotiate with large corporations.[2525] LECs generally argue that, under the 1996 Act, the Commission is precluded from creating an interim pricing regime, and point to section 251(d)(3), which preserves state regulations over the obligations of LECs in certain circumstances, to support their argument.[2526]

c. Discussion

(1) Statutory Standard

1054. We conclude that the pricing standards established by section 252(d)(1) for interconnection and unbundled elements, and by section 252(d)(2) for transport and termination of traffic, are sufficiently similar to permit the use of the same general methodologies for establishing rates under both statutory provisions. Section 252(d)(2) states that reciprocal compensation rates for transport and termination shall be based on "a reasonable approximation of the additional costs of terminating such calls."[2527] Moreover, there is some substitutability between the new entrant's use of unbundled network elements for transporting traffic and its use of transport under section 252(d)(2). Depending on the interconnection arrangements, carriers may transport traffic to the competing carriers' end offices or hand traffic off to competing carriers at meet points for termination on the competing carriers' networks. Transport of traffic for termination on a competing carrier's network is, therefore, largely indistinguishable from transport for termination of calls on a carrier's own network. Thus, we conclude that transport of traffic should be priced based on the same cost-based standard, whether it is transport using unbundled elements or transport of traffic that originated on a competing carrier's network. We, therefore, find that the "additional cost" standard permits the use of the forward-looking, economic cost-based pricing standard that we are establishing for interconnection and unbundled elements.[2528]

[2524] Cincinnati Bell comments at 25-26.

[2525] *Id.*

[2526] *See, e.g.*, BellSouth comments in CC Docket No. 95-185 at 32.

[2527] 47 U.S.C. § 252(d)(2)(A)(ii).

[2528] *See supra*, Section VII.B.

(2) Pricing Rule

1055. States have three options for establishing transport and termination rate levels. A state commission may conduct a thorough review of economic studies prepared using the TELRIC-based methodology outlined above in the section on the pricing of interconnection and unbundled elements.[2529] Alternatively, the state may adopt a default price pursuant to the default proxies outlined below. If the state adopts a default price, it must either commence review of a TELRIC-based economic cost study, request that this Commission review such a study, or subsequently modify the default price in accordance with any revised proxies we may adopt. As previously noted, we intend to commence a future rulemaking on developing proxies using a generic cost model, and to complete such proceeding in the first quarter of 1997. As a third alternative, in some circumstances states may order a "bill and keep" arrangement, as discussed below.

(3) Cost-Based Pricing Methodology

1056. Consistent with our conclusions about the pricing of interconnection and unbundled network elements, we conclude that states that elect to set rates through a cost study must use the forward-looking economic cost-based methodology, which is described in greater detail above, in establishing rates for reciprocal transport and termination when arbitrating interconnection arrangements.[2530] We find that section 252(d)(2)(B)(ii), which indicates that section 252(d)(2) shall not be construed to "authorize the Commission or any State to engage in any rate regulation proceeding to establish with particularity the additional costs of transporting or terminating calls,"[2531] does not preclude states or this Commission from reviewing forward-looking economic cost studies. First, we believe that Congress intended the term "rate regulation proceeding" in section 252(d)(2)(B)(ii) to mean the same thing as "a rate-of-return or other rate-based proceeding" in section 252(d)(1)(A)(i). In the section on the pricing of interconnection and unbundled elements above, we conclude that the statutory prohibition of the use of such proceedings is intended to foreclose the use of traditional rate case proceedings using rate-of-return regulation. Moreover, forward-looking economic cost studies typically involve "a reasonable approximation of the additional cost,"[2532] rather than determining such costs "with particularity," such as by measuring labor costs with detailed time and motion studies.

1057. We find that, once a call has been delivered to the incumbent LEC end office

[2529] *Id.*

[2530] *See supra*, Section VII.B. for a complete discussion of forward-looking economic cost-based methodology.

[2531] 47 U.S.C. § 252(d)(2)(B)(ii).

[2532] 47 U.S.C. § 252(d)(2)(A)(ii).

serving the called party, the "additional cost" to the LEC of terminating a call that originates on a competing carrier's network primarily consists of the traffic-sensitive component of local switching. The network elements involved with the termination of traffic include the end-office switch and local loop. The costs of local loops and line ports associated with local switches do not vary in proportion to the number of calls terminated over these facilities.[2533] We conclude that such non-traffic sensitive costs should not be considered "additional costs" when a LEC terminates a call that originated on the network of a competing carrier. For the purposes of setting rates under section 252(d)(2), only that portion of the forward-looking, economic cost of end-office switching that is recovered on a usage-sensitive basis constitutes an "additional cost" to be recovered through termination charges.

1058. Rates for termination established pursuant to a TELRIC-based methodology may recover a reasonable allocation of common costs. A rate equal to incremental costs may not compensate carriers fully for transporting and terminating traffic when common costs are present. We therefore reject the argument by some commenters that "additional costs" may not include a reasonable allocation of forward-looking common costs. We recognize that, as noted by Time Warner, call termination is an essential element in completing calls because competitors are required to use the incumbent LECs' existing networks to terminate calls to incumbent LEC customers.[2534] The 1996 Act envisions a seamless interconnection of competing networks, rather than the development of redundant, ubiquitous networks throughout the nation. In order to terminate traffic ubiquitously to other companies' local customers, all LECs are given the right to use termination services from those companies rather than construct facilities to everyone. While, on the originating end, carriers have different options to reach their revenue-paying customers -- including their own network facilities, purchasing access to unbundled elements of the incumbent LEC, or resale -- they have no realistic alternatives for terminating traffic destined for competing carriers' subscribers other than to use those carriers' networks. Thus, all carriers -- incumbent LECs as well as competing carriers -- have a greater incentive and opportunity to charge prices in excess of economically efficient levels on the terminating end. To ensure that rates for reciprocal compensation make possible efficient competitive entry, we conclude that termination rates should include an allocation of forward-looking common costs that is no greater proportionally than that allocated to unbundled local loops, which, as discussed above, should be relatively low.[2535] Additionally, we conclude that rates for the transport and termination of traffic shall not include an element that allows incumbent LECs to recover any lost contribution to basic, local service rates represented by the interconnecting carriers' service, because such an element would be

[2533] The duty to terminate calls that originate on the network of a competitor does not directly affect the number of calls routed to a particular end user and any costs that result from inadequate loop capacity are, therefore, not considered "additional costs."

[2534] Time Warner comments at 50.

[2535] *See supra*, Section VII.C.2.b.(1).

inconsistent with the statutory requirement that rates for transport and termination be based on additional costs.[2536] In the section addressing prices for unbundled elements we conclude that the ECPR, which would allow incumbent LECs to recover such lost contributions, or collection of universal service costs through interconnection rates, leads to significant distortions in markets when existing retail prices are not cost-based.[2537]

1059. We also address the impact on small incumbent LECs. For example, the Western Alliance argues that it is especially important for small LECs to recover lost contributions and common costs through termination charges. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, we conclude that termination rates for all LECs should include an allocation of forward-looking common costs, but find that the inclusion of an element for the recovery of lost contribution may lead to significant distortions in local exchange markets. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.

(4) Default Proxies

1060. As with unbundled network elements, we recognize that it may not be feasible for some state commissions conducting or reviewing economic studies to establish transport and termination rates using our TELRIC-based pricing methodology within the time required for the arbitration process, particularly given some states' resource limitations. Thus, for the time being, we adopt a default price range of 0.2 cents ($0.002) to 0.4 cents ($0.004) per minute of use for calls handed off at the end-office switch. This default price range is based on the same proxies that apply to local switching as an unbundled network element. In establishing end-office termination rates, states may adopt a default termination price that is within our default price range or at either of the end points of the range. States should articulate the basis for selecting a particular price within this range. Thus, in arbitration proceedings, states must set the price for end office termination of traffic by: (1) using a forward-looking, economic cost study that complies with the forward-looking, economic-cost methodology set forth above; or (2) adopting a price less than or equal to 0.4 cents ($0.004) per minute, and greater than or equal to 0.2 cents ($0.002) per minute, pending the completion of such a forward-looking, economic cost study. We observe that the most credible studies in the record before us fall at the lower end of this range, and we encourage states to consider such evidence in their analysis. The adoption of a range of rates to serve as a default price range for interconnection agreements being arbitrated by the states provides carriers with a clearer understanding of the terms and conditions that will

[2536] *See* 47 U.S.C. § 252(d)(2).

[2537] *See supra*, Section VII.B.2.b. for a discussion of the effect application of the ECPR would have on the market for local exchange service.

govern them if they fail to reach an agreement and helps to reduce the transaction costs of arbitration and litigation. We also find that states that have already adopted end-office termination rates based on an approach other than a full forward-looking cost study, either through arbitration or rulemaking proceedings, may keep such rates in effect, pending their review of a forward-looking cost study, as long as they do not exceed 0.5 cents ($0.005) per minute. As discussed below, a state may also order a "bill and keep" arrangement subject to certain limitations. Additionally, our adoption of a default price range temporarily relieves small and mid-sized carriers from the burden of conducting forward-looking economic cost studies.[2538]

1061. Similarly, in establishing transport rates under sections 251(b)(5) and 252(d)(2), state commissions should be guided by the price proxies that we are establishing for unbundled transport elements discussed above.[2539] States should explain the basis for selecting a particular default price subject to the applicable ceiling. Specifically, when interconnecting carriers hand off traffic at an incumbent LEC's tandem switch (or equivalent facilities of a carrier other than an incumbent LEC), the rates for the tandem switching and transmission from the tandem switch to end offices -- a portion of the "transport" component of transport and termination rates -- should be subject to the proxies that apply to the analogous unbundled network elements. Thus, for the time being, when states set rates for tandem switching under section 252(d)(2), they may set a default price at or below the default price ceiling that applies to the tandem switching unbundled element as an alternative to reviewing a forward-looking economic cost study using our TELRIC methodology.[2540] Similarly, when states set rates for transmission facilities between tandem switches and end offices, they may establish rates equal to the default prices we are adopting for such transmission, as discussed above in the section on unbundled elements.[2541]

1062. Finally, in establishing the rates for transmission facilities that are dedicated to the transmission of traffic between two networks, state commissions should be guided by the default price level we are adopting for the unbundled element of dedicated transport.[2542] For such dedicated transport, we can envision several scenarios involving a local carrier that provides transmission facilities (the "providing carrier") and another local carrier with which it interconnects (the "interconnecting carrier"). The amount an interconnecting carrier pays for dedicated transport is to be proportional to its relative use of the dedicated facility. For example, if the providing carrier provides one-way trunks that the interconnecting carrier uses exclusively for sending terminating traffic to the providing carrier, then the interconnecting carrier is to pay the

[2538] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2539] *See supra*, Section VII.C.2.b.(3).

[2540] *Id.*

[2541] *Id.*

[2542] *Id.*

providing carrier a rate that recovers the full forward-looking economic cost of those trunks. The interconnecting carrier, however, should not be required to pay the providing carrier for one-way trunks in the opposite direction, which the providing carrier owns and uses to send its own traffic to the interconnecting carrier. Under an alternative scenario, if the providing carrier provides two-way trunks between its network and the interconnecting carrier's network, then the interconnecting carrier should not have to pay the providing carrier a rate that recovers the full cost of those trunks. These two-way trunks are used by the providing carrier to send terminating traffic to the interconnecting carrier, as well as by the interconnecting carrier to send terminating traffic to the providing carrier. Rather, the interconnecting carrier shall pay the providing carrier a rate that reflects only the proportion of the trunk capacity that the interconnecting carrier uses to send terminating traffic to the providing carrier. This proportion may be measured either based on the total flow of traffic over the trunks, or based on the flow of traffic during peak periods.[2543] Carriers operating under arrangements which do not comport with the principles we have set forth above, shall be entitled to convert such arrangements so that each carrier is only paying for the transport of traffic it originates, as of the effective date of this order.

(5) Rate Structure

1063. Nearly all commenters agree that flat rates, rather than usage-sensitive rates, should apply to the purchase of dedicated facilities. As discussed in the NPRM, economic efficiency may generally be maximized when non-traffic sensitive services, such as the use of dedicated facilities for the transport of traffic, are priced on a flat-rated basis.[2544] We, therefore, require all interconnecting parties to be offered the option of purchasing dedicated facilities, for the transport of traffic, on a flat-rated basis. As discussed by Lincoln Telephone, the connection between an incumbent LEC's end or tandem office and an interconnecting LEC's network is likely to be a dedicated facility. We recognize that the facility itself can be provided in a number of different ways -- by use of two service providers, by the other carrier, or jointly in a meet-point arrangement. We conclude first that, no matter what the specific arrangements, these costs should be recovered in a cost-causative manner and that usage-based charges should be limited to situations where costs are usage sensitive. In cases going to arbitration and in reviewing BOC statements of terms and conditions, the carrier actually providing the facility should presumptively be entitled to a rate that is set based on the forward-looking economic cost of providing the portion of the facility that is used for terminating traffic that originates on the network of a competing carrier. We recognize that negotiated agreements may incorporate flat-rated charges when it is efficient to do so and find that the presence of the arbitration default rule is likely to lead parties to negotiate efficient rate structures.

1064. We recognize that the costs of transporting and terminating traffic during peak and

[2543] *See infra*, Section XI.A.3.c.(5).

[2544] NPRM at para. 150.

off-peak hours may not be the same. As suggested by the Massachusetts Attorney General, rates that are the same during peak and off-peak hours may not reflect the cost of using the network and could lead to inefficient use of the network. The differences in the cost of transporting and terminating traffic during peak and off-peak hours, however, are likely to vary depending on the network, and the amount and type of traffic terminated at a particular switch. For example, peak periods may vary within a local service area depending upon whether the switch is located in a business or residential area. As a result, there may be administrative difficulties in establishing peak-load pricing schemes that may outweigh the benefits of such schemes. The negotiating parties, however, are likely to be in a position to more accurately determine how traffic patterns will adjust to peak-load pricing schemes and we encourage parties to address such pricing schemes in the negotiation process. For similar reasons, we neither require nor forbid states from adopting rates that reflect peak and off-peak costs. We hope some states will evaluate the benefits and costs of pricing schemes that consist of different rates for peak and off-peak traffic. We do require, however, that peak-load pricing schemes, adopted through the arbitration process, comply with our default price level if not based on a forward-looking cost study (*e.g.*, the average rate, weighted by the projected relative minutes of use during peak and off-peak periods, should fall within our default price range of 0.2 to 0.4 cents or the level determined by an incremental cost study).

(6) Interim Transport and Termination Rate Levels

1065. We are concerned that some new entrants that do not already have interconnection arrangements with incumbent LECs may face delays in initiating service solely because of the need to negotiate transport and termination arrangements with the incumbent LEC. In particular, a new entrant that has already constructed facilities may have a relatively weak bargaining position because it may be forced to choose either to accept transport and termination rates not in accord with these rules or to delay its commencement of service until the conclusion of the arbitration and state approval process. To promote the Act's goal of rapid competition in the local exchange, we order incumbent LECs upon request from new entrants to provide transport and termination of traffic, on an interim basis, pending resolution of negotiation and arbitration regarding transport and termination prices, and approval by the state commission. A carrier may take advantage of this interim arrangement only after it has requested negotiation with the incumbent LEC. The interim arrangement shall cease to be in effect when one of the following occurs: (1) an agreement has been negotiated and approved; (2) an agreement has been arbitrated and approved; or (3) the period for requesting arbitration has passed with no such request. We also conclude that interim prices for transport and termination shall be symmetrical. Because the purpose of this interim termination requirement is to permit parties without existing interconnection agreements to enter the market expeditiously, this requirement shall not apply with respect to requesting carriers that have existing interconnection arrangements that provide for termination of local traffic by the incumbent LEC. The ability to interconnect with an incumbent LEC prior to the completion of a forward-looking, economic cost study, based on an interim presumptive price ceiling, allows carriers, including small entrants, to enter into local exchange

service expeditiously.[2545]

1066. In states that have already conducted or reviewed forward-looking economic cost studies and promulgated transport and termination rates based on such studies, an incumbent LEC receiving a request for interim transport and termination shall use these state-determined rates as interim transport and termination rates. In states that have not conducted or reviewed a forward-looking economic cost study, but have set rates for transport and termination of traffic consistent with the default price ranges and ceilings discussed above, an incumbent LEC shall use these state-determined rates as interim rates.[2546] In states that have neither set rates consistent with the default price ceilings and ranges nor reviewed or conducted forward-looking economic cost studies, we must establish an interim default price in order to facilitate rapid competition in the local exchange market. In those states, an incumbent LEC shall set interim rates at the default ceilings for end-office switching (0.4 cents per minute of use), tandem switching (0.15 cents per minute of use), and transport described above.[2547] Using the ceiling as a default interim price, pending a state commission's completion of a forward-looking economic cost analysis, should ensure that both the incumbent LEC and the competing provider recovers no less than their full transport and termination costs. We note, however, that the most credible evidence in the record suggests that the actual forward-looking economic cost of end-office switching is closer to 0.2 cents ($0.002) per minute of use than the ceiling of 0.4 cents ($0.004) per minute of use.[2548] States must adopt "true-up" mechanisms to ensure that no carrier is disadvantaged by an interim rate that differs from the final rate established pursuant to arbitration.

1067. We conclude that section 251, in conjunction with our broad rulemaking authority under section 4(i), provides us with authority to create interim pricing rules to facilitate market entry. Because section 251(d)(1) gives the FCC authority "to establish regulations to implement the requirements of this section," we find that section 251(d)(1) gives the Commission authority to establish interim regulations that address the "just and reasonable" rates for the "reciprocal compensation" requirement of section 251(b)(5), subject to the preservation requirements of section 251(d)(3). Courts have upheld our adoption of interim compensation arrangements pursuant to our authority under section 4(i) of the 1934 Communications Act on numerous occasions in the past.[2549] In particular, we have authority, under section 4(i), to set interim rates

---

[2545] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2546] *See supra*, Section XI.A.3.c.(4).

[2547] *Id.*

[2548] *See supra*, Section XI.A.3.c.(4).

[2549] *See New England Tel. and Tel. Co. v. FCC*, 826 F.2d 1101 (D.C. Cir 1987); *North American Telecommunications Association v. FCC*, 772 F.2d 1092 (7th Cir. 1085); *Lincoln Tel. and Tel. Co. v. FCC*, 659 F.2d (D.C. Cir. 1989).

subject to a later "true-up" when final rates are established.[2550] We therefore conclude that the default prices discussed above need not in all instances await the conclusion of the negotiation, arbitration, and state approval process set forth in section 252, but must nevertheless be in accordance with the requirements of section 251(d)(3) preserving state access regulations. We also observe that we proposed a similar interim transport and termination arrangement, albeit with different rate levels, in our NPRM in the *LEC-CMRS Interconnection* proceeding.[2551]

1068. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, Cincinnati Bell asserts that interim mechanisms are not required because large corporations are not disadvantaged by unequal bargaining power in negotiations with small and mid-size incumbent LECs. We do not adopt Cincinnati Bell's position because some new entrants, regardless of their size, that do not already have interconnection arrangements with incumbent LECs may face delays in initiating service solely because of the need to negotiate transport and termination arrangements with the incumbent LEC. We believe that the adoption of interim rates, subject to a "true-up," advances the pro-competitive goals of the statute. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.

4. Symmetry

a. Background

1069. Symmetrical compensation arrangements are those in which the rate paid by an incumbent LEC to another telecommunications carrier for transport and termination of traffic originated by the incumbent LEC is the same as the rate the incumbent LEC charges to transport and terminate traffic originated by the other telecommunications carrier. Incumbent LECs are not likely to purchase interconnection or unbundled elements from competitive LECs, except for termination of traffic, and possibly transport.[2552] In the NPRM, we sought comment on whether

[2550] "[T]he Commission's establishment of an interim billing and collection arrangement was both a helpful and necessary step for the Commission to take in implementing its 'immediate' interconnection order." *Lincoln Telephone & Telegraph Co. v. FCC*, 659 F.2d 1092, 1107 (D.C.Cir.1981) (upholding Commission decision requiring an incumbent LEC to interconnect with MCI immediately, in order not to delay interconnection, at interim rates subject to later adjustment); *see also FTC Communications v. FCC*, 750 F.2d 226 (2d Cir.1984) (affirming Commission's authority under Section 4(i) to set interim rates for interconnection between the domestic record carrier, Western Union, and international record carriers, subject to an accounting order, pending the conclusion of a rulemaking to set permanent rates replacing expired, contract-based rates).

[2551] *LEC-CMRS Interconnection NPRM* at para. 60.

[2552] NPRM at para. 235.

rate symmetry requirements are consistent with the statutory requirement that rates set by states for transport and termination of traffic be based on "costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier," and "a reasonable approximation of the additional costs of terminating such calls."[2553]

1070. In addition, we noted in the NPRM that the Illinois, Maryland, and New York commissions have established different rates for termination of traffic on an incumbent LEC's network, depending upon whether the traffic is handed off at the incumbent LEC's end office or tandem switch.[2554] We also observed that California and Michigan have established one rate that applies to transport and termination of all competing local exchange carrier traffic on incumbent LEC networks, regardless of whether the traffic is handed off at the incumbent LEC's end office or tandem switch, although this rate does not currently apply to CMRS.[2555] We, therefore, address whether rates for transport and termination should be symmetrical and consist of only a single rate regardless of where the call is handed off, or if rates should be priced on an element-by-element basis.

1071. In the *LEC-CMRS Interconnection NPRM*, we sought comment on whether incumbent LECs were utilizing their greater bargaining power to negotiate with wireless carriers interconnection agreements that did not reflect principles of mutual compensation. We sought comment on whether we should institute some procedure or mechanism in addition to our section 208 enforcement process to ensure that incumbent LECs comply with our existing rules requiring mutual compensation.[2556]

b. Comments

1072. *Local Competition NPRM.* Incumbent LECs argue that a symmetrical reciprocal compensation requirement does not comport with the Act.[2557] GTE contends that the symmetry rule violates the requirement of section 252(d)(2) that rates be based on a reasonable estimate of the additional costs of transport and termination.[2558] In addition, Lincoln Telephone argues that rates for the transport and termination of traffic should not be symmetrical because small and

[2553] 47 U.S.C. § 252(d)(2).

[2554] NPRM at para. 239.

[2555] *Id.*

[2556] *LEC-CMRS Interconnection NPRM*, para. 81.

[2557] *See, e.g.*, BellSouth comments at 72-73; SBC comments at 51-52; GTE reply at 29.

[2558] GTE reply at 29.

mid-sized companies can incur higher costs transporting and terminating traffic than larger carriers.[2559] TDS argues that a symmetrical pricing standard fails to fulfill the basic statutory directive that each carrier recover its costs.[2560] BellSouth contends that, because the costs of an incumbent LEC and new entrant are likely to be quite different, the Commission does not have the authority to contravene the mutual and reciprocal recovery language of section 252(d)(2) and require symmetry.[2561] Furthermore, MECA, which represents Michigan exchange carriers, asserts that competing LECs should be required to compensate each other for terminating traffic at a cost-based rate for each carrier.[2562] MECA argues that compensation rates cannot be uniform because each carrier has its own unique cost structure.[2563] RTC also asserts that proposals such as symmetry do not consider the costs involved in the use of another's carriers network.[2564]

1073. On the other hand, state commissions, as well as several other commenters, support symmetrical reciprocal compensation mechanisms.[2565] Several commenters contend that symmetrical rates are mutual and reciprocal, and therefore only symmetrical rates can satisfy the statutory standards required under section 252(d)(2).[2566] MFS notes that Congress required that compensation rates be "mutual and reciprocal" and based on a "reasonable approximation of additional costs," and expressly prohibited any requirement of actual cost studies.[2567] According to MFS "these interrelated provisions indicate Congress's intention that optimal economic costs, rather than actual or historical costs, should be used in setting these rates."[2568] MFS also argues that, while actual costs may vary from one carrier to the next, the optimal economic cost of performing the transport and termination function is the same for all carriers operating within the

[2559] Lincoln Tel. reply at 11-12.

[2560] TDS comments at 23.

[2561] BellSouth comments at 72-73.

[2562] MECA comments at 67.

[2563] *Id.*; *see also* Lincoln Tel. reply at 11.

[2564] RTC comments at 23.

[2565] *See, e.g.*, Alabama Commission comments at 32; AT&T comments at 69; Louisiana Commission comments at 7-8; Mass. Commission comments at 13; MCI comments at 50.

[2566] MFS comments at 82-83; GST comments at 40-42; *see also* Texas Public Utility Counsel comments at 52-54 (arguing that symmetrical rates are consistent with the Act as long as rates are based on TSLRIC).

[2567] MFS comments at 82.

[2568] *Id.*

same geographic area.[2569] Therefore, it asserts that *"[o]nly* symmetrical rates are 'mutual and reciprocal,' and only such rates are consistent with the provisions of Sec. 252(d)(2)."[2570]

1074. Several potential new entrants believe that requiring symmetrical reciprocal compensation is needed to ensure efficient competition.[2571] MCI argues that the reciprocal compensation will be of much greater importance to competing carriers than to incumbent LECs because initially calls terminating on other carriers' networks will account for a far greater share of entrants' traffic than is the case for incumbent LECs, which will still be terminating most of their local traffic on their own networks.[2572] Therefore, MCI asserts that the compensation rate charged for transport and termination will comprise a significant portion of the competing carrier's overall cost of providing service.[2573] MCI argues that incumbent LECs have every reason to attempt to use their superior bargaining position in negotiations to obtain termination rates that are as high as possible, and asserts that a symmetrical compensation rate will reduce the incentive of incumbent LECs to inflate their termination rates.[2574] In addition, MFS asserts that asymmetrical rates burden new entrants because incumbent LECs have greater bargaining power and access to information.[2575] The Alabama Commission contends that equal rates eliminate incumbent LECs' ability to exploit the system.[2576]

1075. Some prospective local entrants contend that requiring symmetrical reciprocal compensation arrangements will lead to economically efficient outcomes.[2577] MFS contends that setting symmetrical rates based on the cost of optimal technology gives all carriers an incentive to use the most efficient network design in order to reduce costs.[2578] Further, GST argues that the long-term efficient cost of transporting and terminating traffic should be identical for all

[2569] *Id.*; *see also* Texas Public Utility Counsel comments at 52-54 (arguing that symmetrical rates based on TSLRIC should not vary much across companies).

[2570] MFS comments at 82 (emphasis in original); *see also* WinStar comments at 24-26; GST comments at 40-42.

[2571] *See, e.g.*, MCI comments at 50-51; MFS comments at 82-84.

[2572] MCI comments at 49-50.

[2573] *Id.*

[2574] *Id.*

[2575] MFS comments at 83.

[2576] Alabama Commission comments at 32.

[2577] *See, e.g.*, MFS comments at 83-84; WinStar comments at 26.

[2578] MFS comments at 84.

providers, based upon their adoption of the most efficient technology, even if their short-term costs based upon today's technology are different.[2579] WinStar argues that asymmetrical cost-based compensation would penalize new entrants for deploying state-of-the-art technology. According to WinStar, such a system would require new entrants to absorb the costs of the incumbent LECs' less efficient networks by paying higher termination rates, while entrants would be required to pass cost savings from their more efficient networks to the less efficient incumbent LECs by charging lower terminations rates.[2580] WinStar asserts that incumbent LECs have no incentive to increase the efficiency of their own operations as long as they remain free to recover the costs of terminating traffic through higher termination rates than those of their competitors.[2581]

1076. Many state commissions and potential new entrants contend that symmetrical rates should be based on the incumbent LEC's costs. AT&T argues that such an approach provides carriers with the proper incentives to minimize costs and has the added benefit of being administratively manageable, given that incumbent LECs will already be performing TSLRIC studies.[2582] In addition, the Massachusetts Commission notes that entrants may not have the expertise or ability to calculate costs for specific services, and supports use of the incumbent LECs' costs to calculate reciprocal compensation rates. The Alabama Commission asserts, however, that reciprocal compensation rates should be set equal to the transport and termination rates charged by entrants.[2583] Noting that some new entrants may have higher costs than incumbent LECs, several commenters argue that, while reciprocal compensation generally should be symmetrical based on incumbent LECs' costs, new entrants should be able to prove their costs are higher than the incumbent LECs' rates.[2584] Lincoln Telephone, on the other hand, opposes a symmetry requirement because it "achieves expediency at the expense of economic efficiency, thereby eliminating some of the benefits of competition under the Act."[2585]

1077. Several commenters, including many states, contend that this issue should be left to the states or parties to decide.[2586] The California Commission suggests that symmetry should be

[2579] GST comments at 35-38.

[2580] WinStar comments at 26.

[2581] *Id.*

[2582] AT&T comments at 69; *see also* Texas Public Utility Counsel comments at 52-54.

[2583] Alabama Commission comments at 32.

[2584] *See, e.g.*, Mass. Commission comments at 13; Sprint comments at 83.

[2585] Lincoln Tel. comments at 22.

[2586] *See, e.g.*, Ohio Commission comments at 73-75; Illinois Commission comments at 79-80; Pennsylvania Commission comments at 40; Ohio Consumers' Counsel reply at 24.

encouraged by the Commission but not mandated.[2587] NYNEX claims that, although the statute does not require symmetrical rates, parties may agree to such a scheme in a negotiated agreement.[2588]

1078. Certain commenters argue that any symmetry requirement should only apply to separate rate elements. The Ohio Commission supports symmetrical rates on a rate element-by-rate element basis (*e.g.*, local switching rate element, local transport rate element).[2589] For example, the Ohio Commission would not endorse symmetrical rates for transport and termination where a new entrant requests interconnection with an incumbent LEC's tandem office, and the new entrant does not have tandem capabilities.[2590] In that case, terminating a call on the new entrant's network typically would involve only the use of local switching and local transport between the interconnection point and the LEC's switch. In contrast, terminating a call on the incumbent LEC's network often is likely to involve the use of the incumbent LEC's tandem switch in addition to the local switch and the transport between the two switching offices.[2591] Bell Atlantic argues that the reciprocal compensation rate for calls delivered to an access tandem for which the terminating carrier will incur the cost of tandem switching and transport should be allowed to be higher than rates for calls delivered to an end office, which do not incur those additional costs.[2592]

1079. MFS opposes a two-tier termination rate structure under which one rate applies for traffic routed through an incumbent LEC's tandem switch, and a lower rate applies to traffic directly trunked to an incumbent LEC's end office. MFS asserts that these rate structures are inherently non-reciprocal because non-incumbent LECs typically do not operate separate tandem and end-office hierarchies.[2593] Time Warner argues that transport and termination based on incumbent LECs' historical choices of network architecture penalizes new LECs that deploy different architectures, even when that architecture is more efficient.[2594] TCI argues that higher charges for routing calls through tandem switches rather than directly through the incumbent LEC's end offices will discourage carriers from routing traffic through tandem switches, even

[2587] California Commission comments at 44.

[2588] NYNEX reply at 43-44.

[2589] Ohio Commission comments at 73-75

[2590] *Id.* at 73-74.

[2591] *Id.*

[2592] Bell Atlantic comments at 43.

[2593] MFS comments at 77-78; *see also* NCTA reply at 14-15.

[2594] Time Warner comments at 87-88; *see also* Continental comments at 13-14; Winstar comments at 26.

when it is efficient to do so.[2595]

1080. *LEC-CMRS Interconnection NPRM.* Many CMRS providers contend that they are unable to negotiate interconnection arrangements based on mutual or reciprocal compensation because of incumbent LEC bargaining power.[2596] In its reply comments, Omnipoint asserts that many interconnection agreements across the CMRS industry reflect a general incumbent LEC unwillingness to provide reciprocal compensation.[2597] SBC argues, however, that CMRS providers have significant bargaining power and numerous options for interconnection.[2598] Ameritech states that it continues to fulfill the principles of mutual compensation in all of its CMRS compensation arrangements.[2599]

1081. Although the incumbent LECs generally contend that good faith negotiations are working well,[2600] most CMRS providers comment that the negotiation process works poorly.[2601] According to AT&T, the problem of achieving mutual compensation is further compounded because incumbent LECs not only charge rates that bear no relationship to their costs but also refuse to compensate CMRS providers for termination of landline-originated calls.[2602] In many instances, incumbent LECs even charge CMRS providers for terminating incumbent LEC-originated calls.[2603] GTE, however, states that it does not charge CMRS providers for land-to-

[2595] TCI comments at 28.

[2596] *See, e.g.*, Nextel comments in CC Docket No. 95-185 at 5; Tracer reply in CC Docket No. 95-185 at 8; Vanguard comments in CC Docket No. 95-185 at 6; *see also* CTIA comments in CC Docket No. 95-185 at 8.

[2597] Omnipoint reply in CC Docket No. 95-185 at 3-7; *see also* RCC comments in CC Docket No. 95-185 at 5; 360 Degrees comments in CC Docket No. 95-185 at 3; Western Wireless comments in CC Docket No. 95-185 at 13.

[2598] SBC comments in CC Docket No. 95-185 at 13.

[2599] Ameritech comments in CC Docket No. 95-185 at 4.

[2600] *See, e.g.*, GTE comments in CC Docket No. 95-185 at 18; Ameritech comments in CC Docket No. 95-185 at 4.

[2601] *See, e.g.*, APC/Sprint Joint comments in CC Docket No. 95-185 at 11; PCIA reply in CC Docket No. 95-185 at 6-8; *see also* Cox comments in CC Docket No. 95-185 at 12-16; AT&T reply in CC Docket No. 95-185 at 4-8.

[2602] AT&T comments in CC Docket No. 95-185 at 8; *see also* Western Wireless comments in CC Docket No. 95-185 at 13; New Par comments in CC Docket No. 95-185 at 5.

[2603] *See, e.g.*, Arch comments in CC Docket No. 95-185 at 3; Centennial comments in CC Docket No. 95-185 at 9; Century comments in CC Docket No. 95-185 at 4; CMT comments in CC Docket No. 95-185 at 4; Nextel comments in CC Docket No. 95-185 at 5.

mobile traffic.[2604] California has rejected the principle of mutual compensation for interconnection, reasoning that such a policy would lead to a calling-party-pays system, which in turn could lead to an increase in the cost of basic telephone service.[2605] CMRS providers report that they receive mutual compensation from only a handful of the incumbent LECs with which they interconnect.[2606]

1082. CMRS providers generally agree that many interconnection arrangements result in unjust, unreasonable and discriminatory interconnection rates, terms and conditions.[2607] According to Cox, the average incremental cost of call termination, expressed on a per minute basis is .20 cents, but the average charge for cellular interconnection is currently 3 cents per minute.[2608] Similarly, Comcast states that the aggregate charge it pays Bell Atlantic for call termination is 2.5 cents per minute, or 12.5 times the average incremental cost of 0.2 cents.[2609] In contrast, the incumbent LECs assert that incumbent LEC interconnection rates have provided for reasonable charges.[2610] A few incumbent LECs also point to the lack of interconnection rate complaints filed in their respective regions as evidence of reasonable rates.[2611] Cox responds that "the fact that few complaints have been filed does not lead to the conclusion that existing agreements are reasonable, let alone that they promote competition."[2612] U S West contends that, until the local rate subsidy issue is addressed, reform in CMRS interconnection charges will not come to fruition.[2613]

[2604] GTE comments in CC Docket No. 95-185 at 19-20.

[2605] California Commission comments in CC Docket No. 95-185 at 6.

[2606] *See, e.g.*, Bell Atlantic/NYNEX Mobile comments in CC Docket No. 95-185 at 4-5.

[2607] *See, e.g.*, Comcast comments in CC Docket No. 95-185 at 4; Vanguard comments in CC Docket No. 95-185 at 7.

[2608] Cox comments in CC Docket No. 95-185 at 13.

[2609] Comcast comments in CC Docket No. 95-185 at 5-6.

[2610] *See, e.g.*, Pacific Bell reply in CC Docket No. 95-185 at 16-27; U S West comments in Docket 95-185 at 6-8.

[2611] *See, e.g.*, Bell Atlantic comments in CC Docket No. 95-185 at 9-11; NYNEX comments in CC Docket No. 95-185 at 13-15, 22-23; Ameritech comments in CC Docket No. 95-185 at 4; USTA comments in CC Docket No. 95-185 at 7.

[2612] Cox reply in CC Docket No. 95-185 at 6; *see also* New Par reply in CC Docket No. 95-185 at 7; PageNet reply CC Docket No. 95-185 at 5-7.

[2613] US West reply in CC Docket No. 95-185 at 5. US West alleges that access and local interconnection must be priced above cost to provide a subsidy to local residential services that remain priced below cost.

1083. The incumbent LECs further assert that, aside from anecdotal commentary, CMRS providers submit no evidence that their market entry or growth has been impeded by state or incumbent LEC action with respect to interconnection.[2614] The incumbent LECs argue that CMRS is developing rapidly under existing compensation arrangements and therefore current interconnection policies apparently do not pose a barrier to CMRS competition.[2615] U S West contends that CMRS providers have benefitted from negotiations that have resulted in declining interconnection charges as well as added flexibility with the introduction of calling-party-pays and wide area calling options.[2616] Many CMRS providers contend, however, that the industry may have grown faster had it not been impeded by unreasonable interconnection rates.[2617] Some incumbent LECs also point out that interconnection charges only represent a small percentage of a CMRS provider's total operating costs.[2618] But according to Airtouch, interconnection charges represent a growing proportion of CMRS costs.[2619]

1084. According to most paging companies, incumbent LEC abuses are especially acute for narrowband CMRS providers.[2620] Because virtually 100 percent of paging calls are originated on incumbent LEC networks and terminated on CMRS networks, incumbent LEC abuses, it is argued, present a formidable barrier to entry in the CMRS marketplace.[2621] Most paging carriers allege that incumbent LECs charge narrowband CMRS providers for terminating LEC-originated calls on the paging network but do not compensate narrowband CMRS providers for terminating incumbent LEC originated traffic.[2622] Many narrowband CMRS providers also allege discrimination because the charges assessed to paging companies for connection to the landline network are different from the charges assessed on other CMRS providers, and that many of these

[2614] *See, e.g.*, NYNEX reply in CC Docket No. 95-185 at 4; Pacific Bell reply in CC Docket No. 95-185 at 13-16.

[2615] *See, e.g.*, USTA reply in CC Docket No. 95-185 at 2-5.

[2616] US West comments in CC Docket No. 95-185 at 7-12.

[2617] *See, e.g.*, Vanguard reply in CC Docket No. 95-185 at 9; PageNet reply in CC Docket No. 95-185 at 7.

[2618] US West CC Docket No. 95-185 comments at 16; USTA reply in CC Docket No. 95-185 at 4-5. SBC estimates that interconnection charges represent 5.5 to 7 percent of a CMRS provider's total operating costs. SBC reply in CC Docket No. 95-185 at 18.

[2619] *See, e.g.*, Airtouch reply in CC Docket No. 95-185 at 10-13.

[2620] *See, e.g.*, Airtouch comments in CC Docket No. 95-185 at 59.

[2621] *See* Celpage comment in CC Docket No. 95-185 at 6.

[2622] *See e.g.*, Arch comments in CC Docket No. 95-185 at 6; Celpage comments in CC Docket No. 95-185 at 6.

interconnection charges are not substantiated with adequate cost data.[2623]

c. Discussion

(1) Symmetry In General

1085. Regardless of whether the incumbent LEC's transport and termination prices are set using a TELRIC-based economic cost study or a default proxy, we conclude that it is reasonable to adopt the incumbent LEC's transport and termination prices as a presumptive proxy for other telecommunications carriers' additional costs of transport and termination. Both the incumbent LEC and the interconnecting carriers usually will be providing service in the same geographic area, so the forward-looking economic costs should be similar in most cases. We also conclude that using the incumbent LEC's forward-looking costs for transport and termination of traffic as a proxy for the costs incurred by interconnecting carriers satisfies the requirement of section 252(d)(2) that costs be determined "on the basis of a reasonable approximation of the additional costs of terminating such calls." Using the incumbent LEC's cost studies as proxies for reciprocal compensation is consistent with section 252(d)(2)(B)(ii), which prohibits "establishing with particularity the additional costs of transporting or terminating calls."[2624] If both parties are incumbent LECs (*e.g.*, an independent LEC and an adjacent BOC), we conclude that the larger LEC's forward-looking costs should be used to establish the symmetrical rate for transport and termination. We conclude that larger LECs are generally in a better position to conduct a forward-looking economic cost study than smaller carriers.

1086. We conclude that imposing symmetrical rates based on the incumbent LEC's additional forward-looking costs will not substantially reduce carriers' incentives to minimize those costs. A symmetric compensation rule gives the competing carriers correct incentives to minimize its own costs of termination because its termination revenues do not vary directly with changes in its own costs. Moreover, symmetrical rates based on the incumbent LEC's costs should not seriously affect incumbent LECs' incentives to control costs. We expect that incumbent LECs will transport and terminate much more traffic that originates on their own networks than traffic that originates on competing carriers' networks. Even if, under the additional cost standard, incumbent LECs were required to reflect any improvements in operating efficiency, and consequent cost reductions, in reduced termination rates, the cost savings realized by the incumbent LEC are likely to be much greater than its reduction in net termination revenues, because the majority of traffic transported and terminated is likely to be its own. Even if a pass-through of incumbent LEC's cost reductions were instantaneous and complete, the number of minutes of use on which an incumbent LEC's net termination revenues is assessed is much smaller than its overall number of minutes of switching and transport. Moreover, if a

[2623] *See, e.g.*, Arch comments in CC Docket No. 95-185 at 23-25.

[2624] 47 U.S.C. §252(d)(2)(B)(ii).

portion of the reduction in costs is specific to exchange traffic, under symmetrical rates, the LEC's revenues from terminating traffic originating from another local carrier are based on the net difference in traffic, which is likely to be much smaller than the total traffic it terminates.[2625] For example, in the case where traffic is balanced, net termination charges are zero, a figure that is unaffected by changes in the incumbent LEC's costs, and the incumbent LEC is provided with correct incentives to minimize termination costs.

1087. We also find that symmetrical rates may reduce an incumbent LEC's ability to use its bargaining strength to negotiate excessively high termination charges that competitors would pay the incumbent LEC and excessively low termination rates that the incumbent LEC would pay interconnecting carriers. As discussed by commenters in the *LEC-CMRS Interconnection* proceeding, LECs have used their unequal bargaining position to impose asymmetrical rates for CMRS providers and, in some instances, have charged CMRS providers origination as well as termination charges.[2626] On the other hand, symmetrical rates largely eliminate such advantages because they require incumbent LECs, as well as competing carriers, to pay the same rate for reciprocal compensation.

1088. Symmetrical compensation rates are also administratively easier to derive and manage than asymmetrical rates based on the costs of each of the respective carriers. In addition, we believe that using the incumbent LEC's cost studies to establish the presumptive symmetrical rates will establish reasonable opportunities for local competition, including opportunities for small telecommunications companies entering the local exchange market.[2627] We have considered the economic impact of our rules in this section on small incumbent LECs. For example, RTC argues that symmetrical rates do not consider the costs involved in the use of another carrier's network. We find, however, that incumbent LECs' costs, including small incumbent LECs' costs, serve as reasonable proxies for other carriers' costs of transport and termination for the purpose of reciprocal compensation. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state

[2625] Consider a situation approximating traditional LEC-CMRS interconnection, in which traffic flows are substantially unbalanced: let us suppose, of 1,000,000 minutes of use, 750,000 are CMRS-to-LEC and 250,000 LEC-to-CMRS. Thus, under symmetric compensation at 0.3 cents per minute, the LEC receives 0.3 cents times 500,000, or $1,500.00. If it reduced its per-minute cost, for some reason only on terminating CMRS-to-LEC traffic, to 0.2 cents per minute, it would save 0.1 cent times 750,000, or $750.00, in reduced costs, whereas its terminating revenues would fall by only 0.1 cent times 500,000, or $500.00. Thus, it would still have substantial incentive to make the cost reduction in question. In situations closer to traffic balance, the incentive is even more favorable. And, of course, the LEC probably also reduces its cost of switching on many millions of other minutes that do not involve other networks at the same time.

[2626] *See, e.g.*, Century Comments in CC Docket No. 95-184 at 4; Western Wireless Comments in CC Docket No. 95-185 at 14.

[2627] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act. In addition, symmetry will avoid the need for small businesses to conduct forward-looking economic cost studies in order for the states to arbitrate reciprocal compensation disputes.[2628]

1089. Given the advantages of symmetrical rates, we direct states to establish presumptive symmetrical rates based on the incumbent LEC's costs for transport and termination of traffic when arbitrating disputes under section 252(d)(2) and in reviewing BOC statements of generally available terms and conditions. If a competing local service provider believes that its cost will be greater than that of the incumbent LEC for transport and termination, then it must submit a forward-looking economic cost study to rebut this presumptive symmetrical rate. In that case, we direct state commissions, when arbitrating interconnection arrangements, to depart from symmetrical rates only if they find that the costs of efficiently configured and operated systems are not symmetrical and justify a different compensation rate. In doing so, however, state commissions must give full and fair effect to the economic costing methodology we set forth in this order, and create a factual record, including the cost study, sufficient for purposes of review after notice and opportunity for the affected parties to participate. In the absence of such a cost study justifying a departure from the presumption of symmetrical compensation, reciprocal compensation for the transport and termination of traffic shall be based on the incumbent local exchange carrier's cost studies.

1090. We find that the "additional costs" incurred by a LEC when transporting and terminating a call that originated on a competing carrier's network are likely to vary depending on whether tandem switching is involved. We, therefore, conclude that states may establish transport and termination rates in the arbitration process that vary according to whether the traffic is routed through a tandem switch or directly to the end-office switch. In such event, states shall also consider whether new technologies (*e.g.*, fiber ring or wireless networks) perform functions similar to those performed by an incumbent LEC's tandem switch and thus, whether some or all calls terminating on the new entrant's network should be priced the same as the sum of transport and termination via the incumbent LEC's tandem switch. Where the interconnecting carrier's switch serves a geographic area comparable to that served by the incumbent LEC's tandem switch, the appropriate proxy for the interconnecting carrier's additional costs is the LEC tandem interconnection rate.

1091. We disagree with TCI's claim that higher charges for routing calls through tandem switches rather than directly through incumbent LECs' end offices will materially discourage carriers from routing traffic through tandem switches, even when it is efficient to do so. New entrants will only be encouraged to interconnect at end-office switches, rather than tandem switches, when the decrease in incumbent LEC transport charges justifies the extra costs incurred by the new entrant to route traffic directly through the incumbent LEC's end-office switches.

[2628] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

Carriers will interconnect in a way that minimizes their costs of interconnection, including the use of cost-based LEC network elements. In addition, the flexibility given to states may allow carriers, including small entities, with different network architectures to establish rates for terminating calls originating on other carriers' networks that are asymmetrical, if they can show that the costs of efficiently configured and operated systems are not symmetrical and justify different compensation rates, instead of being based on competitors' network architectures.[2629]

1092. We believe, with respect to interconnection between LECs and paging providers, that there should be an exception to our rule that states must establish presumptive symmetrical rates based on the incumbent LEC's costs for transport and termination of traffic. While paging providers, as telecommunications carriers, are entitled to mutual compensation for the transport and termination of local traffic, and should not be required to pay charges for traffic that originates on other carriers' networks, we believe that incumbent LECs' forward-looking costs may not be reasonable proxies for the costs of paging providers. Paging is typically a significantly different service than wireline or wireless voice service and uses different types and amounts of equipment and facilities. PageNet's own network, for example, is based on a regional hub and spoke network that transmits paging calls from radio transmitters to provide regional or national coverage.[2630] This configuration is distinctly different from either LEC wireline networks, with their hierarchy of switches and transmission facilities, or cellular carriers, with their multiple cells and sophisticated systems for handing off calls as a vehicle moves across cell boundaries. In addition, most calls terminated by paging companies are brief (averaging 15 seconds) in duration and contain no voice message, but only an alpha-numeric message of a few characters.[2631] Using incumbent LEC's costs for termination of traffic as a proxy for paging providers' costs, when the LECs' costs are likely higher than paging providers' cost, might create uneconomic incentives for paging providers to generate traffic simply in order to receive termination compensation. Thus, using LEC costs for termination of voice calls thus may not be a reasonable proxy for paging costs as the types of switching and transport that paging carriers perform are different from those of LECs and other voice carriers.

1093. Given the lack of information in the record concerning paging providers' costs to terminate local traffic, we have decided to initiate a further proceeding to try to determine what an appropriate proxy for paging costs would be and, if necessary, to set a specific paging default proxy. In the interim, however, in the event that LECs and paging companies cannot negotiate agreed-upon rates, we direct states, when arbitrating disputes under section 252(d)(2), to establish rates for the termination of traffic by paging providers based on the forward-looking economic

[2629] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2630] PageNet comments in CC Docket No. 95-185 at 34.

[2631] Letter from Carl W. Northrop, Paul, Hastings, Janofsy & Walker, on behalf of Arch Communications to Michele Farquhar, Chief, WTB, July 11, 1996.

costs of such termination to the paging provider. The paging provider seeking termination fees must prove to the state commission the costs of terminating local calls. Given the lack of information in the record concerning paging providers' costs, we further conclude that the default price for termination of traffic from the end office that we adopt in this proceeding in Section XI.A.3., *supra*, does not apply to termination of traffic by paging providers. This default price is based on estimates in the record of the costs to LECs of termination from the end office or end-office switching. There are no such estimates with respect to paging in the record, and as discussed above, we find that estimates of LEC costs may not reflect paging providers' costs.

(2) Existing Non-Reciprocal Agreements Between Incumbent LECs and CMRS Providers

1094. Section 20.11 of our rules, which predates enactment of the 1996 Act, requires that interconnection agreements between incumbent LECs and CMRS providers comply with principles of mutual compensation, and that each carrier pay reasonable compensation for transport and termination of the other carrier's calls.[2632] Based on the extensive record in the *LEC-CMRS Interconnection* proceeding, as well as that in this proceeding, we conclude that, in many cases, incumbent LECs appear to have imposed arrangements that provide little or no compensation for calls terminated on wireless networks, and in some cases imposed charges for traffic originated on CMRS providers' networks, both in violation of section 20.11 of our rules.[2633] Accordingly, we conclude that CMRS providers that are party to pre-existing agreements with incumbent LECs that provide for non-mutual compensation have the option to renegotiate these agreements with no termination liabilities or other contract penalties. Pending the successful completion of negotiations or arbitration, symmetrical reciprocal compensation provisions shall apply, with the transport and termination rate that the incumbent LEC charges the CMRS provider from the pre-existing agreement applying to both carriers, as of the effective date of the rules we adopt pursuant to this order.

1095. In addition, we conclude that this opportunity for CMRS providers currently operating under arrangements with non-mutual transport and termination rates to renegotiate such arrangements advances the mutual compensation regime contemplated under section 251(b)(5) of

[2632] 47 C.F.R. § 20.11.

[2633] *See, e.g.*, Centennial comments in Docket 95-185 at 8-9 (states that it does not receive compensation for terminating LEC-originated traffic in any of its 28 cellular markets, and is charged by the LEC to terminate LEC-originated calls in many of those markets); Century Cellunet comments in Docket 95-185 (states that it does not receive compensation from LECs to terminate landline originating calls, and that in some states, it must pay the LEC to terminate landline originating calls; further states that it is charged an average rate of $0.025 per minute for local interconnection); Point Communications comments in Docket 95-185 at 1 (Point has never received compensation for terminating landline originated calls); and Vanguard Cellular comments in Docket 95-185 at 7--8; 11 (notes that of the 95 LECs with which it interconnects, only one LEC in one community pays compensation for termination of LEC-originated calls).

the 1996 Act.[2634] We find that extending the opportunity to establish symmetrical reciprocal compensation for the transport and termination of traffic addresses inequalities in bargaining power that incumbent LECs may used to disadvantage interconnecting wireless carriers. At the same time, our rule will place wireless carriers with non-mutual, existing agreements on the same footing as other new entrants, who will be able to negotiate more equitable interconnection agreements because of the rules we put in place with this Report and Order. We find that we have ample authority under section 4(i) of the 1934 Act as well as section 251 of the 1996 Act, to order this remedy. Courts have held that "the Commission has the power to prescribe a change in contract rates when it finds them to be unlawful . . . and to modify other provisions of private contracts when necessary to serve the public interest."[2635] The opportunity that we are affording to CMRS providers in this context is consistent with similar "fresh look" requirements that we have adopted in the past.[2636]

5. Bill and Keep

a. Background

1096. *Local Competition NPRM.* In the NPRM, we defined bill-and-keep arrangements as those in which neither of two interconnecting networks charges the other network for terminating traffic that originated on the other network.[2637] Instead, each network recovers from its own end users the cost of both originating traffic delivered to the other network and terminating traffic received from the other network. A bill-and-keep approach for termination of traffic does not, however, preclude a positive flat-rated charge for transport of traffic between carriers' networks.

[2634] We use the term "reciprocal compensation" and "mutual compensation" synonymously to mean that compensation flows in both directions between interconnecting networks. *See LEC-CMRS Interconnection NPRM* at para. 27 n.31.

[2635] *Western Union Tel. Co. v. FCC*, 815 F.2d 1495, 1501 (D.C. Cir. 1987). The Commission has adopted similar "fresh look" requirements in the past.

[2636] *See, e.g., Expanded Interconnection with Local Telephone Company Facilities*, CC Docket Nos. 91-141 and 92-222, Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, 7463-7465 (1992), *recon.*, 8 FCC Rcd 7341, 7342-7359 (1993) (fresh look to enable customers to take advantage of new competitive opportunities under special access expanded interconnection), *vacated on other grounds and remanded for further proceedings sub nom. Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441 (1994); *Competition in the Interstate Interexchange Marketplace*, CC Docket No. 90-132, Memorandum Opinion and Order on Reconsideration, 7 FCC Rcd 2677, 2681-82 (1992) ("fresh look" in context of 800 bundling with interexchange offerings); *Amendment of the Commission's Rules Relative to Allocation of the 849-851/894-896 MHz Bands*, GEN Docket No. 88-96, Memorandum Opinion and Order on Reconsideration, 6 FCC Rcd 4582, 4583-84 (1991) ("fresh look" requirements imposed in context of air-ground radiotelephone service as condition of grant of Title III license).

[2637] NPRM at para. 239.

1097. We sought comment on what guidance we should give state commissions regarding the use of bill-and-keep arrangements in arbitrated interconnection arrangements.[2638] We sought comment on whether section 252(d)(2)(B)(ii) specifically authorizes states to impose bill-and-keep arrangements in the arbitration process, at least when certain conditions are met.[2639] We also sought comment on whether we should interpret the statute as placing any limits on the circumstances in which states may adopt bill-and-keep arrangements.[2640] We also asked for comment on the meaning of the statutory description of bill-and-keep arrangements as "arrangements that waive mutual recovery."[2641] In addition, we sought comment on whether there are any circumstances in which the statute requires states to establish bill-and-keep arrangements.[2642]

1098. *LEC-CMRS Interconnection NPRM.* In the *LEC-CMRS Interconnection NPRM*, we proposed bill and keep as an interim arrangement.[2643] We noted there that proponents have argued that bill-and-keep would be economically efficient if either of two conditions are met: (1) traffic flows between competing LECs are balanced; or (2) the per-unit cost of interconnection is *de minimis*. We, therefore, address whether interim bill-and-keep arrangements for LEC-CMRS traffic should be imposed.

b. Comments

1099. *Local Competition NPRM.* Numerous new entrants and state commissions contend that bill-and-keep arrangements are expressly authorized by the statute.[2644] Non-incumbent LECs argue that section 252(d)(2) makes clear that bill-and-keep satisfies the reciprocal compensation duties of section 251(b)(5). Therefore, pursuant to the Commission's broad authority to adopt implementing regulations via section 251(d)(1), and consistent with the interconnection pricing standards, they argue that the Commission has the authority to require a bill-and-keep reciprocal

---

[2638] NPRM at para. 243.

[2639] *Id.*

[2640] *Id.*

[2641] *Id.* (*citing* 47 U.S.C. § 252(d)(2)(B)(i)).

[2642] *Id.*

[2643] *See LEC-CMRS Interconnection NPRM* at paras. 60-62.

[2644] *See, e.g.*, Continental comments at 11; GST comments at 34-35; California Commission comments at 45-46; Time Warner comments at 93, reply at 34-37; Omnipoint comments at 15; Hyperion comments at 20-21; WinStar reply at 12.

compensation mechanism.[2645] Continental and NCTA assert, contrary to some incumbent LEC arguments, that section 252(b)(2)(B)(i) does not limit bill-and-keep to situations in which incumbent LECs waive their right to some other form of compensation, but instead clarifies that regulators are not precluded from imposing or approving such waivers.[2646] Numerous state commissions contend that reciprocal compensation issues should be left to the states to decide, and that states have the authority to impose bill-and-keep arrangements.[2647] Many of these commenters further argue that, while states have the authority to require bill-and-keep arrangements, the Commission does not have the authority to mandate these arrangements.[2648]

1100. Incumbent LECs as well as certain other commenters contend that mandatory bill-and-keep requirements conflict with the 1996 Act.[2649] Numerous incumbent LECs also argue that bill-and-keep arrangements fail the "reasonable approximation of the additional costs" test of section 252(d)(2) because they would effectively price termination at zero.[2650] For example, RTC argues that bill and keep fails to adequately deal with each carrier's costs and should not be considered, even as an interim proposal.[2651] Cincinnati Bell contends that the statute merely authorizes bill-and-keep arrangements in voluntary negotiations and only parties to the negotiation can properly assess if such an arrangement would be appropriate.[2652] In response to Cincinnati Bell's argument, potential new entrants counter that the only reasonable interpretation of section 252(d)(2) is that regulators may impose bill and keep over the objection of an incumbent LEC.[2653] They assert that this is the only logical interpretation because section 252(d)(2) only applies to

[2645] *See, e.g.*, Time Warner comments at 93-94; ACSI comments at 21-26. *But see* Ohio Consumers' Counsel reply at 24 (contending that Time Warner's argument is circular).

[2646] Continental comments at 11 n.15; NCTA comments at 55; *cf.* Cox reply at 19.

[2647] *See, e.g.*, Louisiana Commission comments at 20; Illinois Commission comments at 80; District of Columbia Commission comments at 37-38; Florida Commission comments at 40; *see also* Ohio Consumers' Counsel reply at 24.

[2648] *See, e.g.*, Illinois Commission comments at 80; District of Columbia Commission comments at 38.

[2649] *See, e.g.*, Ameritech comments at 78-79; PacTel comments at 95; SBC comments at 51-52; GTE comments at 56-58; BellSouth comments at 73-74; Cincinnati Bell comments at 38-39; Frontier comments at 32; Washington Independent Tel. Ass'n comments at 4; TDS comments at 24; ALTS comments at 45.

[2650] *See, e.g.*, NYNEX comments at 88-90; Ameritech Comments at 78-79; Bell Atlantic comments at 41-42; PacTel comments at 95; USTA comments at 82-84; U S West comments at 70-71.

[2651] RTC comments at 23.

[2652] Cincinnati Bell comments at 38-39.

[2653] *See, e.g.*, Jones Intercable comments at 27; NCTA reply at 15; ALTS reply at 31 n.37; Comcast reply at 12-14.

arbitration cases. If parties reach an agreement to use bill-and-keep arrangements, this section would not apply.[2654]

1101. Proponents of bill-and-keep arrangements contend that these arrangements minimize the administrative costs associated with metering and billing that would be incurred under other compensation methods.[2655] In addition, because there currently may be no mechanism readily available to new entrants for measuring terminating traffic, states and new entrants argue that the cost of measurement and billing under a reciprocal compensation agreement is not known.[2656] TCG asserts that bill-and-keep arrangements would reduce small carriers burdens by eliminating billing and monitoring requirements and the potential for carrier disputes.[2657] MCI asserts that termination measurement and billing costs would represent a substantial portion of termination costs.[2658] It notes that in the state of Washington, US West estimated that measurement and billing costs would more than double its reported TSLRIC cost of switching for local terminations.[2659] Other benefits of a bill-and-keep arrangement presented by commenters include: (1) elimination of incentives to "game" the LEC-to-LEC relationship by soliciting (or avoiding) customers with high incoming or outgoing usage;[2660] (2) architectural and technological neutrality;[2661] (3) the reduction of economic barriers to entry because it does not require additional capital investment that other arrangements would necessitate;[2662] and (4) economic efficiency.[2663] USTA, however, asserts that alternative local service providers will have no economic incentives

[2654] *Id.*

[2655] *See, e.g.*, California commission at 45; DOJ comments at 34-35; Teleport comments at 77; Jones Intercable comments at 28-29; Mass. Attorney General comments at 19. *But see* Bell Atlantic reply at Exhibit 2, p.8 (Richard Epstein, a witness for Bell Atlantic, argues that bill-and-keep may lead to habitual overconsumption by the party terminating less traffic that will be significantly more costly than administrative cost savings).

[2656] *See, e.g.*, Colorado Commission comments at 59; AT&T comments at 69; Sprint comments at 86-87; ACSI comments at 22-23.

[2657] TCG comments at 80.

[2658] MCI comments at 48.

[2659] *Id.; see also* Teleport comments at 77.

[2660] *See, e.g.*, Jones Intercable comments at 27-28; GST comments at 34-35; MCI comments at 53.

[2661] *See* Mass. Attorney General comments at 19.

[2662] *See, e.g.*, Telecommunications Resellers Ass'n comments at 54.

[2663] *See, e.g.*, Jones Intercable comments at 28; ACSI comments at 21-26; Competitive Policy Institute reply at 15-17.

to use the lower cost facilities or service under bill-and-keep arrangements.[2664]

1102. Potential new entrants observe that bill-and-keep arrangements have traditionally been used by neighboring incumbent LECs for exchanging traffic. Thus, they argue, bill-and-keep arrangements represent a fair mechanism for the exchange of traffic between new entrants and incumbent LECs.[2665] In response to this argument, MECA counters that compensation arrangements should not be patterned after EAS interconnections between incumbent LECs because those EAS arrangements were not designed for the competitive environment.[2666]

1103. Numerous commenters address the issue of the likely balance of traffic between a new entrant and an incumbent LEC. New entrants argue that in most cases traffic between incumbent LECs and competing LECs will be relatively balanced over time[2667] and that additional costs to terminate traffic on already over-built incumbent LEC networks are close to zero.[2668] In addition, the Consumer Federation of America contends that once barriers to competition (*e.g.*, number portability) are removed there is no reason to believe that there will be substantial incentives to seek heavy outgoing-only customers.[2669] While acknowledging that bill-and-keep arrangements may be problematic if traffic levels exchanged are significantly different, other new entrants argue that critics have failed to produce any evidence of materially uneven traffic loadings.[2670] MECA, however, argues that a bill-and-keep reciprocal compensation mechanism is flawed because it is premised on the assumption that terminating traffic will be equal in both directions for competing LECs.[2671] MECA argues that this assumption is incorrect because new entrants will engage in niche marketing to get a toehold in a new service area, and therefore the size of each carrier's customer base will be different and the total number of originating minutes

[2664] USTA comments at Attachment (Affidavit of Jerry A. Hausman), p. 9-10; *see also* BellSouth comments at Attachment (Interconnection and Economic Efficiency), p. 8-10; Bell Atlantic reply at Attachment (Declaration of Richard A. Epstein) p. 8 (adopting bill and keep would invite new entrants, that are able to tailor their networks, to keep traffic perpetually out of balance, as, for example, by actively courting companies, such as telephone solicitors, that generate a huge volume of outgoing calls).

[2665] *See, e.g.*, Sprint/APC comments at 11-12; TCI comments at 27; Continental comments at 10.

[2666] MECA comments at 69.

[2667] Time Warner comments at 97-98; *see also* TCI comments at 35-37.

[2668] Time Warner comments at 98-99; *see also* Teleport comments at 81-83.

[2669] CFA/CU comments at 55.

[2670] *See, e.g.*, ACSI comments at 24; GST comments at 34-35.

[2671] MECA comments at 68-69.

will differ.[2672]

1104. Numerous new entrants and state commissions recommend that bill-and-keep arrangements be implemented on an interim basis[2673] and note that reciprocal compensation arrangements will not be practical until mechanisms are developed to measure the relevant traffic volumes.[2674] Ameritech, however, argues that parties advocating mandating bill-and-keep arrangements on an interim basis do not take into account that the period during which the new carriers first enter a local market will be the time during which traffic is most unbalanced between the new entrants and the incumbent LEC.[2675] BellSouth argues that characterizing bill and keep as an interim arrangement does not remedy the problems associated with bill and keep.[2676]

1105. Some commenters opposed to bill-and-keep arrangements also argue that mandating these arrangements violates the takings clause of the Fifth Amendment.[2677] Numerous incumbent LECs argue that mandating bill-and-keep arrangements requires a LEC to transport and terminate traffic of another LEC, constituting a physical intrusion into the LEC's property.[2678] BellSouth further asserts that bill and keep would lead to no compensation for use of incumbent LEC property and will therefore constitute an uncompensated taking in violation of the Constitution.[2679] AT&T responds that there is no basis for the argument that bill and keep would be a taking.[2680] AT&T asserts that these claims are speculative and rest on an erroneous premise that bill-and-

[2672] MECA comments at 68-69; *but see* GST comments at 34-35 (using compensation systems other than bill-and-keep would encourage new entrants to focus entry strategies on niches that exploit compensation levels).

[2673] *See, e.g.*, Alabama Commission comments at 32; GST comments at 34-35; AT&T comment at 69; Cox comments at 27-28, 38-39; Sprint comments at 87; Jones Intercable comments at 28-29; Mass. Attorney General comments at 14, 21; Telecommunication Resellers Ass'n comments at 54-55.

[2674] *See, e.g.*, AT&T comments at 69; Colorado Commission at 59.

[2675] Ameritech reply at 36.

[2676] BellSouth reply at 40.

[2677] *See, e.g.*, Bell Atlantic comments at 41-42; Cincinnati Bell comments at 39 n.71; USTA comments at 84; U S West comments at 70-71; GTE comments at 57-58; BellSouth comments at 74-75.

[2678] *See, e.g.*, BellSouth comments at 74-75; Bell Atlantic comments at 41.

[2679] BellSouth comments at 74-75.

[2680] AT&T reply at 36; *see also* ALTS reply at 31; Cox reply at 21-22; Comcast reply at 14; Teleport reply at 20-22.

keep would provide no (or inadequate) compensation.[2681] AT&T argues that, as Congress recognizes, bill and keep allows each carrier in-kind compensation in the form of access to the other carrier's network.[2682] Similarly, Ohio Consumers' Counsel argues that a bill-and-keep mechanism makes each company whole through its own rate design and structure. As such, Ohio Consumers' Counsel argues that allegations that bill and keep means that a competing carrier gets to use the incumbent LEC's network for free cannot withstand scrutiny.[2683] NCTA asserts that bill and keep is not "physical occupation" of the incumbent LEC property, and furthermore does not authorize an invasion of incumbent LEC property, any more than it authorizes incumbent LECs to invade a new entrant's property.[2684] In response to the confiscation argument, NCTA contends that rate regulation does not violate the takings clause unless it is so "unjust as to destroy the value of the property for all purposes for which it was acquired."[2685]

1106. Some wireless commenters argue that bill-and-keep arrangements are not appropriate for incumbent LEC-narrowband CMRS or incumbent LEC-paging reciprocal compensation.[2686] ProNet argues that, because paging carriers' incremental termination costs are above zero and there is no evidence that paging demand is inelastic, imposing bill and keep would likely result in serious resource misallocation.[2687] In addition, PageNet argues that, with respect to paging, the cost of termination is not small and in fact comprises a significant portion of the total revenue requirement for paging services.[2688] With respect to rural incumbent LECs, Bay Spring argues that states should be prohibited from adopting bill-and-keep arrangements to the extent that they force rural incumbent LECs to terminate other carriers' calls on their rural networks without compensation.[2689]

[2681] *Id.*

[2682] AT&T reply at 36; *see also* Washington Commission comments at 3, 38; Teleport comments at 68.

[2683] Ohio Consumers' Counsel comments at 44.

[2684] NCTA reply at 16; *see also* Cox reply at 21-22.

[2685] *Id.* at 17 (*citing Duquesne Light Co. v. Barasch*, 109 S.Ct. 609, 615 (1989), and *Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 579 (1896)).

[2686] *See, e.g.*, ProNet comments at 11; PageNet comments at 11.

[2687] ProNet comment at 11-12.

[2688] PageNet comments at 11.

[2689] Bay Springs, et. al comments at 17; *see also* GVNW comments at 41; Bay Springs et. al reply at 11-12 (incremental termination costs are higher for small LECs because the smaller size of their networks reduce economies of scale).

1107. *LEC-CMRS Interconnection NPRM.* CMRS providers, with the exception of paging providers, generally support the Commission's proposal to adopt an interim bill-and-keep compensation mechanism.[2690] Some supporters of an interim bill-and-keep compensation model argue that it should be adopted on a permanent basis,[2691] and others argue that it should be extended to transport charges.[2692] PageNet and other paging providers oppose application of a bill-and-keep compensation mechanism to the paging industry because traffic flows are entirely one-way.[2693] Sprint supports application of an interim bill-and-keep model solely for incumbent LEC-PCS interconnection.[2694]

1108. Most CMRS providers contend that bill and keep is an appropriate interim compensation mechanism because the incremental cost of incumbent LEC-CMRS interconnection is so low that there is little difference between a cost-based and zero rate.[2695] Cox and other commenters cite the Brock study's conclusions that the national average incremental cost of incumbent LEC-CMRS interconnection is 0.2 cents per minute and that the off-peak cost is close to zero as support for adoption of an interim bill-and-keep model.[2696] Cox contends that none of the incumbent LECs has submitted evidence that the average incremental cost of call termination is anything other than 0.2 cents per minute.[2697] In addition, APC notes that it has relatively balanced traffic flows with incumbent LECs[2698] and a number of CMRS providers assert that incumbent LEC-cellular traffic flows will become more balanced in the future.[2699] AT&T states

---

[2690] *See, e.g.*, AirTouch comments in CC Docket No. 95-185 at 20; CTIA comments in CC Docket No. 95-185 at 7; Comcast comments in CC Docket No. 95-185 at 9.

[2691] *See, e.g.*, New Par comments in CC Docket No. 95-185 at 10; NC 4 Cellular comments in CC Docket No. 95-185 at 1.

[2692] *See, e.g.*, MCI comments in CC Docket No. 95-185 at 5; Nextel comments in CC Docket No. 95-185 at 9; Omnipoint comments in Docket No. 95-185 at 8.

[2693] PageNet comments in CC Docket No. 95-185 at 23; *see also, e.g.*, Allied comments in CC Docket No. 95-185 at 8; Arch comments in CC Docket No. 95-185 at 11.

[2694] Sprint comments in CC Docket No. 95-185 at 7.

[2695] *See, e.g.*, Cox comments in CC Docket No. 95-185 at 29-30.

[2696] Cox comments in CC Docket No. 95-185 at 23; *see also* New Par comments in CC Docket No. 95-185 at 12.

[2697] Cox reply in CC Docket No. 95-185 at 41-42; *see also* Comcast reply in CC Docket No. 95-185 at 17-22.

[2698] APC comments in CC Docket No. 95-185 at 9.

[2699] *See, e.g.*, PCIA comments in CC Docket No. 95-185 at 8; Time Warner comments in CC Docket No. 95-185 at 21.

that any traffic imbalances are offset by the higher cost to CMRS providers of terminating incumbent LEC-originated calls.[2700] Similarly, CTIA asserts that the relevant inquiry is whether the costs each carrier incurs to terminate traffic are balanced, not whether total traffic is balanced.[2701] Some commenters argue that bill and keep is necessary to curb incumbent LEC market power and to remedy incumbent LECs' failure to provide mutual compensation.[2702]

1109. Incumbent LEC commenters, however, generally oppose the Commission's proposal to adopt an interim bill-and-keep compensation mechanism.[2703] A number of incumbent LECs contend that neither of the two conditions that justify a bill-and-keep compensation mechanism -- balanced traffic flows or interconnection costs near zero -- are present in the context of incumbent LEC-CMRS interconnection.[2704] SBC states that bill-and-keep is inappropriate where 80 percent of traffic is CMRS-to-incumbent LEC.[2705] USTA asserts that CMRS interconnection causes incumbent LECs to incur costs for which they should be compensated, and estimates that those costs are 1.3 cents ($0.013) per minute.[2706] Other incumbent LECs contend that the Brock study underestimates the costs of incumbent LEC-CMRS interconnection, but provide no cost estimates of their own.[2707] In addition, many opponents of bill-and-keep contend that it will create market distortions and encourage arbitrage.[2708] Some incumbent LEC commenters assert that incumbent LECs will be unable to recover from ratepayers the lost revenues from LEC-CMRS interconnection charges,[2709] and that bill and keep

[2700] AT&T comments in CC Docket No. 95-185 at 10.

[2701] CTIA reply in CC Docket No. 95-185 at 12-14.

[2702] *See, e.g.*, CTIA comments in CC Docket No. 95-185 at 9; Telecommunications Resellers Ass'n comments in CC Docket No. 95-185 at 8.

[2703] *See, e.g.*, Bell Atlantic comments in CC Docket No. 95-185 at 6; BellSouth comments in CC Docket No. 95-185 at 20; NTCA comments in CC Docket No. 95-185 at 8. *But see* Teleport comments in CC Docket No. 95-185 at 2.

[2704] *See, e.g.*, Ameritech comments in CC Docket No. 95-185 at 8-9, Cincinnati Bell comments in CC Docket No. 95-185 at 4-5.

[2705] SBC comments in CC Docket No. 95-185 at 12.

[2706] USTA comments in CC Docket No. 95-185 at 24, Attachment (Bill and Keep: A Bad Solution to a Non-Problem), p. 8.

[2707] *See, e.g.*, BellSouth comments in CC Docket No. 95-185 at 24.

[2708] *See, e.g.*, Pacific Bell comments in CC Docket No. 95-185 at 11, 60.

[2709] *See, e.g.*, BellSouth comments in CC Docket No. 95-185 at 28; NYNEX comments in CC Docket No. 95-185 at 34; U S West comments in CC Docket No. 95-185 at 25.

is an unlawful taking.[2710] U S West disputes the Commission's contention that bill-and-keep is administratively efficient because, it argues, carriers will still have to develop billing and accounting systems.[2711]

1110. Several commenters propose alternatives to the Commission's proposed bill-and-keep interim compensation mechanism. For example, Frontier suggests that the Commission adopt a benchmark compensation scheme similar to that offered by Ameritech in Illinois, which sets a rate of .5 cents ($0.005) per minute for end office termination and .75 cents ($0.0075) per minute for tandem termination.[2712] CMS recommends that bill and keep apply for a two year voluntary period, after which a mandatory negotiation period under bill and keep would be imposed if the parties fail to reach agreement.[2713] RCC proposes that bill and keep be used only until a "carrier access billing system" can be implemented.[2714]

c. Discussion

1111. As an additional option for reciprocal compensation arrangements for termination services, we conclude that state commissions may impose bill-and-keep arrangements if neither carrier has rebutted the presumption of symmetrical rates and if the volume of terminating traffic that originates on one network and terminates on another network is approximately equal to the volume of terminating traffic flowing in the opposite direction, and is expected to remain so, as defined below. We disagree with commenters who contend that the Commission and states do not have the authority to mandate bill-and-keep arrangements under any circumstances. Section 252(d)(2)(B)(i) provides that the definition of what may be considered "just and reasonable" terms and conditions for reciprocal compensation "shall not be construed to preclude arrangements that afford mutual recovery (such as bill-and-keep arrangements)."[2715] We conclude that section 252(d)(2) would be superfluous if bill-and-keep arrangements were limited to negotiated agreements, because none of the standards in section 252(d) apply to voluntarily-negotiated agreements. Therefore, it is clear that bill-and-keep arrangements may be imposed in the context of the arbitration process for termination of traffic, at least in some circumstances.

[2710] *See, e.g.*, Bell Atlantic comments in CC Docket No. 95-185 at 8; BellSouth comments in CC Docket No. 95-185 at 20; Pacific Bell comments in CC Docket No. 95-185 at 79; U S West comments in CC Docket No. 95-185 at 49.

[2711] U S West comments in CC Docket No. 95-185 at 39-40.

[2712] Frontier comments in CC Docket No. 95-185 at 9.

[2713] CMS comments in CC Docket No. 95-185 at 17.

[2714] RCC comments in CC Docket No. 95-185 at 8-9.

[2715] 47 U.S.C. § 252(d)(2)(B)(i).

1112. Section 252(d)(2)(A)(i) provides that to be just and reasonable, reciprocal compensation must "provide for the mutual and reciprocal recovery by each carrier of costs associated with transport and termination."[2716] In general, we find that carriers incur costs in terminating traffic that are not *de minimis*, and consequently, bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs. In addition, as long as the cost of terminating traffic is positive, bill-and-keep arrangements are not economically efficient because they distort carriers' incentives, encouraging them to overuse competing carriers' termination facilities by seeking customers that primarily originate traffic. On the other hand, when states impose symmetrical rates for the termination of traffic,[2717] payments from one carrier to the other can be expected to be offset by payments in the opposite direction when traffic from one network to the other is approximately balanced with the traffic flowing in the opposite direction. In such circumstances, bill-and-keep arrangements may minimize administrative burdens and transaction costs. We find that, in certain circumstances, the advantages of bill-and-keep arrangements outweigh the disadvantages, but no party has convincingly explained why, in such circumstances, parties themselves would not agree to bill-and-keep arrangements. We are mindful, however, that negotiations may fail for a variety of reasons. We conclude, therefore, that states may impose bill-and-keep arrangements if traffic is roughly balanced in the two directions and neither carrier has rebutted the presumption of symmetrical rates.

1113. We further conclude that states may adopt specific thresholds for determining when traffic is roughly balanced. If state commissions impose bill-and-keep arrangements, those arrangements must either include provisions that impose compensation obligations if traffic becomes significantly out of balance or permit any party to request that the state commission impose such compensation obligations based on a showing that the traffic flows are inconsistent with the threshold adopted by the state.[2718] States may, however, also apply a general presumption that traffic between carriers is balanced and is likely to remain so. In that case, a party asserting imbalanced traffic arrangements must prove to the state commission that such imbalance exists. Under such a presumption, bill-and-keep arrangements would be justified unless a carrier seeking to rebut this presumption satisfies its burden of proof. We also find that states that have adopted bill-and-keep arrangements prior to the date that this order becomes effective, either in arbitration or rulemaking proceedings, may retain such arrangements, unless a party proves to the state commission that traffic is not roughly balanced. In that case, the state commission is to determine the termination rates based either on the forward-looking economic cost-based methodology or consistent with the default proxies in this order. Finally, we observe

[2716] 47 U.S.C.§ 252(d)(2)(A)(i).

[2717] *See infra*, Section XI.A.4.c. for a discussion of symmetrical rates.

[2718] For example, the Michigan Commission adopted a five percent threshold for the difference between the traffic flows in the two directions. Michigan Commission comments at Attachment 1 (Michigan Public Service Commission Case No. U-10647), p.29.

that carriers have an incentive to agree to bill-and-keep arrangements if it is economically efficient to do so, and that nothing in the Act prevents parties from agreeing to bill-and-keep arrangements even if a state declines to mandate such arrangements. For example, we note that Time Warner/BellSouth interconnection agreement provides for a bill-and-keep arrangement based on a "roughly balanced traffic" concept.[2719]

1114. In determining whether traffic is balanced, we find that precise traffic measurement is not necessary. It is sufficient to use approximations based on samples and studies comparable to reports on percentages of interstate use often used for access charge billing. Such an approach is likely to reduce implementation costs and complexities. Alternatively, state commissions may require that traffic flowing in the two directions be measured as accurately as possible during some defined period of time, which may commence no later than six months after an interconnection arrangement goes into effect. All affected carriers are required to cooperate with the state commission in implementing this measurement. A state commission that adopts a traffic flow measurement approach may adopt a "true-up" mechanism to ensure that no carrier is disadvantaged by an interim rate that differs from the rate established once such a measurement is undertaken. Finally, state commissions may require that local traffic and access traffic be carried on separate trunk groups if they deem such measures to be necessary to ensure accurate measurement and billing.

1115. We have considered the economic impact of our rules in this section on small incumbent LECs. For example, RTC argues that bill-and-keep arrangements fail to adequately deal with each carrier's costs.[2720] In addition to basing reciprocal compensation on the incumbent LECs costs, we believe that by allowing carriers to rebut a presumption of balanced traffic volumes, the concern that bill-and-keep arrangements fail to adequately deal with each carrier's costs are addressed. We also note that certain small incumbent LECs are not subject to our rules under section 251(f)(1) of the 1996 Act, unless otherwise determined by a state commission, and certain other small incumbent LECs may seek relief from their state commissions from our rules under section 251(f)(2) of the 1996 Act.

1116. We disagree with commenters that argue that mandating bill-and-keep arrangements

[2719] Letter from W.W. Jordan, Executive Director, BellSouth, to William F. Caton, Acting Secretary, FCC, July 11, 1996. Per the agreement, no party shall owe compensation to the other unless the net minutes of use for terminating local traffic results in a dollar amount in excess of the amount designated for each month during the calculation period as follows: (1) during the first six month period of operation, no charges shall accrue, or compensation paid for the termination of local traffic, however, parties shall exchange billing information and usage data during this initial period for the purpose of reviewing for accuracy only; (2) during the second six months, $40,000 per month/billing period; (3) during the third six months, $30,000 per month/billing period; (4) during the fourth six months, $20,000 per month/billing period; and (5) during any extension of this agreement pursuant to Article II, paragraph 2.03, $0 per month/billing period.

[2720] RTC comments at 23.

in these circumstances violates the taking clause of Fifth Amendment. We reject BellSouth's argument that mandating bill-and-keep mechanisms would constitute a physical intrusion of LEC property. As NCTA observes, bill-and-keep arrangements are not a "physical occupation" of incumbent LEC property and thus *per se* takings cases[2721] are irrelevant. We also reject arguments that the bill-and-keep arrangements we adopt here would not adequately compensate incumbent LECs for transport and termination. As Congress recognized, bill-and-keep arrangements allow each carrier compensation "in-kind" in the form of access to the other carrier's network.[2722] Therefore, the type of bill-and-keep arrangements that we have permitted states to adopt are not unconstitutionally confiscatory.

1117. Commenters in the *LEC-CMRS Interconnection NPRM* assert that the estimated per minute cost of LEC termination ranges from 0.2 to 1.3 cents, and most of the estimates are clustered near the lower end of this range.[2723] These estimates are based primarily on interconnection at a LEC end office,[2724] while most interconnections occur at tandem offices where LECs' costs of call completion are higher than terminations routed directly through the end office switch.[2725] Moreover, the record contains no estimates of the cost of CMRS termination. That cost is generally considered to be greater than the cost of LEC termination;[2726] but only one oral, *ex parte* estimate of CMRS cost has been offered: 2.25 to 4.0 cents per minute.[2727] Further, there is no showing that the transaction costs of measuring traffic flows and making net payments would be so high that a bill-and-keep regime would be more efficient. Moreover, no party has demonstrated that aggregate cost flows between interconnecting LECs and CMRS providers are in balance.

[2721] *See Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426 (1982); *Lucas v. South Carolina Coastal Council*, 112 S.Ct. 2886, 2893 (1992).

[2722] Joint Explanatory Statement at 120.

[2723] For the .2 cents per minute estimate, see letter from Robert F. Roche, CTIA, to William F. Caton, Acting Secretary, Federal Communications Commission, filed in CC Docket No. 94-54, Gerald W. Brock, *The Economics of Interconnection: Incremental Cost of Local Usage* (April 1995). For the 1.3 cents per minute estimate, *see* USTA Comments, CC Docket No. 95-185, submission of Jeffrey H. Rohlfs, Harry M. Shooshan III, and Calvin S. Monson, at 9-10.

[2724] *See supra*, Section VII.C.2.b.(2), for a complete discussion of cost estimates for terminations at both the end office and tandem office switches.

[2725] U S West comments in CC Docket No. 95-185 Attachment A (In Response to Dr. Gerald Brock by Professor Robert G. Harris), p. 11-14.

[2726] *See, e.g.*, AT&T comments in CC Docket No. 95-185 at Attachment (Declaration of Bruce M. Owen), p. 5-6.

[2727] Steven R. Brenner and Bridger M. Mitchell, CTIA *ex parte* briefing, CC Docket No. 95-185, Mar. 21, 1996.

1118. In light of the overall transport and termination policy we are adopting, we do not adopt the interim bill and keep arrangement tentatively proposed in the LEC-CMRS Interconnection NPRM. Notwithstanding our conclusions about bill and keep above, under which states may rule on bill and keep for particular pairs of firms based on the circumstances prevailing between them, we conclude that we are correct in not adopting bill and keep as a single, nationwide policy that would govern all LEC-CMRS transport and termination of traffic. Thus, we reject our tentative conclusion in the LEC-CMRS Interconnection NPRM. We expect, however, that when it is economically efficient to do so, parties will adopt bill and keep arrangements in the negotiation process. Also, as described above, a state commission may impose bill-and-keep arrangements with respect to CMRS-LEC traffic when it finds that traffic is roughly balanced and is expected to remain so.

B. ACCESS TO RIGHTS OF WAY

1. Overview

1119. Section 251(b)(4) imposes upon each LEC the "duty to afford access to the poles, ducts, conduits, and rights-of-way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224."[2728] The access provisions of section 224, as amended by the 1996 Act, differ from the requirements of section 251(b)(4) with respect to both the entities required to grant access and the entities that may demand access. Section 224(f)(1) imposes upon all utilities,[2729] including LECs, the duty to "provide a cable television system or any telecommunications carrier with nondiscriminatory access to any pole, duct, conduit, or right-of-way owned or controlled by it."[2730] For purposes of section 224, the term "telecommunications carrier" excludes any incumbent LEC as that term is defined in section 251(h).[2731]

1120. In the NPRM, we sought comment on various aspects of this access requirement, as well as on section 224(f)(2) which creates the following limited exception to the obligations of section 224(f)(1):

> Notwithstanding paragraph (1), a utility providing electric service may deny a cable

[2728] 47 U.S.C. § 251(b)(4).

[2729] A "utility" is "any person who is a local exchange carrier or an electric, gas, water, steam, or other public utility, and who owns or controls poles, ducts, conduits, or rights-of-ways used, in whole or in part, for wire communications," but does not include any railroad, any cooperative, or any federally or state-owned entities. 47 U.S.C. § 224(a)(1).

[2730] 47 U.S.C. § 224(f)(1). *See* 47 U.S.C. § 153(44) (definition of "telecommunications carrier").

[2731] 47 U.S.C. § 224(a)(5).

television system or any telecommunications carrier access to its poles, ducts, conduits, or rights-of-way, on a non-discriminatory basis where there is insufficient capacity and for reasons of safety, reliability and generally applicable engineering purposes.[2732]

1121. Additionally, we sought comment on section 224(h), which provides:

> Whenever the owner of a pole, duct, conduit, or right-of-way intends to modify or alter such pole, duct, conduit, or right-of-way, the owner shall provide written notification of such action to any entity that has obtained an attachment to such conduit or right-of-way so that such entity may have a reasonable opportunity to add to or modify its existing attachment. Any entity that adds to or modifies its existing attachment after receiving such notification shall bear a proportionate share of the costs incurred by the owner in making such pole, duct, conduit, or right-of-way accessible.[2733]

1122. In this Order, we establish rules implementing these provisions. Based on the comments received and the plain language of the statute, and in furtherance of our original mandate to institute an expeditious procedure for determining just and reasonable pole attachment rates with a minimum of administrative costs and consistent with fair and efficient regulation,[2734] we adopt herein a program for nondiscriminatory access to poles, ducts, conduits and rights-of-way. This Order includes several specific rules as well as a number of more general guidelines that are designed to give parties flexibility to reach agreements on access to utility-controlled poles, ducts, conduits, and rights-of-way, without the need for regulatory intervention. We provide for expedited dispute resolution when good faith negotiations fail, and we establish requirements concerning modifications to pole attachments and the allocation of the cost of such modifications. We also explain the division of responsibility between federal and state regulation envisioned by the 1996 Act.

2. Section 224(f): Non-discriminatory access

a. Background

1123. Pursuant to section 224(f)(1), a utility must grant telecommunications carriers and cable operators nondiscriminatory access to all poles, ducts, conduits, and rights-of-way owned or

[2732] 47 U.S.C. § 224(f)(2).

[2733] 47 U.S.C. § 224(h).

[2734] S. Rep. No. 580, 95th Cong., 1st Sess. 19 (1977).

controlled by the utility.[2735] This directive seeks to ensure that no party can use its control of the enumerated facilities and property to impede, inadvertently or otherwise, the installation and maintenance of telecommunications and cable equipment by those seeking to compete in those fields. Section 224(f)(1) appears to mandate access every time a telecommunications carrier or cable operator seeks access to the utility facilities or property identified in that section, with a limited exception allowing electric utilities to deny access "where there is insufficient capacity and for reasons of safety, reliability and generally applicable engineering purposes."[2736] While Congress recognized the legitimate interests of utilities in protecting and promoting the safety and reliability of their core services, on balance we believe section 224(f) reflects Congress' determination that utilities generally must accommodate requests for access by telecommunications carriers and cable operators.

b. Comments

1124. The comments relating to nondiscriminatory access describe in substantial detail a wide variety of largely technical issues and concerns. We will review the finer points raised by commenters in subsequent discussion sections devoted to particular issues. Here, we discuss the comments to the extent they provide an overview of access issues and we summarize the positions of the parties generally.

1125. NEES states that, historically, providers of electric and telephone services have installed and maintained transmission and distribution lines overhead and underground.[2737] According to NEES, the methods by which utilities install and maintain facilities vary depending upon a number of factors, including the type of utility service provided, the specific type of equipment being used, and various local conditions and regulations. Utilities state that their facilities often occupy public rights-of-way with other utilities or are constructed on private property pursuant to easements granted by the property owners.[2738] Utilities often are empowered to take property by eminent domain in order to install facilities and provide service.[2739] Because

[2735] As noted, a utility's obligations under section 224(f)(1), however, do not extend to incumbent LECs which are excluded from the definition of "telecommunications carriers" under section 224(a)(5). *See infra*, Section E(3)(c) for a discussion of the incorporation of this provision into section 251(b)(4).

[2736] 47 U.S.C. § 224(f)(2).

[2737] Facilities used to transport electricity generally can be divided into transmission facilities and distribution facilities. Transmission facilities deliver bulk power at high voltages across long distances for the ultimate use of a large number of customers. Distribution facilities deliver electricity at lower voltages to individual subscribers within a community. Electric transmission and distribution lines can be installed either on overhead poles and towers, or within underground ducts and conduit. NEES comments at 3.

[2738] PECO comments at 2-3; NEES comments at 4.

[2739] PECO comments at 2-3; Duquesne comments at 14-15.

of economic factors and space considerations, new entrants in the utility fields, as well as providers of cable television and other services, generally must "piggyback" on the poles and conduits of the incumbent utilities in order to provide service.[2740]

1126. The relationship between the general access requirement of section 224(f)(1) and the limited exception contained in section 224(f)(2) reflects long-standing, and sometimes contentious, relationships between utilities and various service providers seeking access to those facilities.[2741] Historically, access to utility poles, conduits, and other facilities has been governed by private pole attachment agreements entered into between the parties in accordance with a patchwork of federal, state, and local regulations and industry standards.[2742] Commenters extensively debate the extent to which our rules implementing section 224(f)(1) and (f)(2) should incorporate various aspects of these standards and requirements. Many utilities claim that existing regulations and standards, including those imposed unilaterally by individual utility companies, should continue to be observed.

1127. Generally, utilities argue that the nondiscrimination obligations set forth in the Act should not be triggered when a utility's facility has not previously been used by cable or telecommunications service providers.[2743] Requiring access accommodation, it is argued, may constitute a taking under the Fifth Amendment takings clause because the right to exclude others from the facility is an inherent attribute of property ownership that would be compromised by mandated access provisions.[2744] Alternatively, some parties suggest that, if access is allowed, utilities should have substantial discretion to set the terms and conditions of such access depending on the nature of the service involved because different technologies present varying levels of risk.[2745] Utilities contend that a wide variety of issues arise in the pole attachment context and that national rules governing questions of access would fail to accommodate the range of concerns that could justify a denial of access.[2746] For this reason, they request that the Commission eschew national rules in favor of individual case adjudication when a cable operator

[2740] *See* Cole comments at 1-3 & n. 1-5.

[2741] *See* Cole comments at 1-7; GST comments at 4.

[2742] American Electric comments at 26; Delmarva reply at 7.

[2743] UTC comments at 6-7.

[2744] American Electric Power comments at 7-10. We discuss these comments in more detail in a separate section devoted to constitutional issues. *See infra*, Section C.

[2745] ConEd comments at 12.

[2746] Carolina Power & Light comments at 4; Virginia Electric comments at 13; American Electric comments at 32-38.

or telecommunications carrier is denied access to a utility's pole or other facility.[2747] Electric utilities, in their comments, request that distinctions be made between facilities used for electric power and those used for other services, including telecommunications services.

1128. On the issue of capacity constraints, utilities strongly favor explicit provisions that would allow utilities to reserve capacity sufficient to meet future needs.[2748] They suggest space reservations are critical to enable utilities to meet expansion plans and ensure the fulfillment of existing obligations. For example, reserve space may be needed for the emergency replacement of failed components.[2749] Although capacity can sometimes be expanded, utilities argue for authority to deny access when providing access would require the expansion of existing capacity.[2750] If Congress intended utilities to expand existing capacity to accommodate new service providers, they argue, it would have granted utilities the power of eminent domain for this purpose.[2751]

1129. Utility commenters present various approaches to determining the amount of reserved capacity that should be recognized under the Commission's rules. Some oppose precise quantifiable reservations, advocating instead a case-by-case adjudication of the allowed reservation with deference to a utility's prior practices.[2752] At least one commenter, however, supports quantifiable limits as a safe harbor for access denials and suggests that a utility be permitted to reserve of 25% of remaining pole space.[2753]

1130. As for safety and reliability factors upon which access can be denied, utilities urge the Commission to resist the adoption of specific rules because the circumstances affecting safety and reliability are too diverse for precise regulatory packaging. One commenter suggests that the method of delivering electricity varies among utilities and a single set of safety rules would not account for these varying delivery methods.[2754] Although utilities have indicated that some broad

[2747] Duquesne Light comments at 3-4; Public Service Company of New Mexico comments at 5-7; NEES comments at 15.

[2748] PECO comments at 7-8; Duquesne comments at 17; NU System Companies comments at 4-5; American Electric comments at 23-24.

[2749] NU System Companies comments at 5;

[2750] American Electric comments at 21; Kansas City Power & Light comments at 3.

[2751] New Mexico Public Service comments at 15.

[2752] Duquesne comments at 17; NU System Companies comments at 5.

[2753] ConEd comments at 10.

[2754] Duquesne comments at 21.

national safety standards, such as the National Electric Safety Code ("NESC"),[2755] may be useful to guide parties regarding access generally, they argue stricter standards beyond such accepted codes would not be workable. Instead, utilities propose case-by-case adjudication of disputes because the range of applicable circumstances will frustrate attempts at regulatory specificity.[2756]

1131. To some degree, the comments of LECs reflect concerns similar to those expressed by electric utilities. With respect to the definition of nondiscrimination, however, the Commission received a diverse range of opinion from LEC commenters. Some LECs argue that nondiscrimination does not require parity with the access terms that a facility owner provides to itself because the statute does not explicitly require such parity,[2757] or because requiring parity would work an unconstitutional taking by relegating a facility owner to non-owning status.[2758] Other LECs argue that nondiscrimination obligates facility owners to provide access similar to what the owner provides to itself for similar uses.[2759] Another commenter suggests that the requirement of nondiscrimination prohibits discrimination against entities competing against the facility owner's affiliate, but does not necessarily require parity as long as the facility owner does not impose unreasonable impediments on the use of the facility by unaffiliated entities.[2760]

1132. Generally, LECs oppose detailed rules regarding nondiscrimination and access, arguing in favor of flexibility to accommodate individual circumstances,[2761] and to promote private industry negotiation.[2762] LEC commenters cite a variety of situations that, in their view, present circumstances that cannot be regulated beyond the articulation of broad guidelines or principles. They argue against the imposition of standards for determining sufficient capacity because utilities need flexibility to make good faith judgments about future service demands.[2763] One LEC commenter, however, advocates capacity reservations based on a five-year business

[2755] 1993 National Electric Safety Code, Institute of Electrical and Electronics Engineers, Inc. (1992).

[2756] PECO comments at 6; NEES comments at 14.

[2757] Ameritech comments at 34; PacTel comments at 19-20.

[2758] GTE comments at 23-24.

[2759] Bell Atlantic comments at 13; NYNEX comments at 14.

[2760] PacTel comments at 19-21.

[2761] PacTel comments at 18.

[2762] SBC comments at 15-16; GTE comments at 22-23; Rural Tel. Coalition at 10.

[2763] USTA comments at 10; Ameritech comments at 37; BellSouth comments at 14-15; PacTel comments at 20.

forecast.[2764]

1133. Similarly, LECs oppose specific standards governing access denials due to safety and engineering concerns. LECs argue that municipal rules have governed this area for years, obviating the need for federal guidelines.[2765] In their view, established safety codes exist and additional standards imposed at the federal level may conflict with these accepted standards.[2766] A wide variety of concerns could affect the safety and reliability of a network and attachments to poles within a network, according to commenters, including wind resistance, local height regulations, working space requirements between attachments, national safety codes and federal and state occupational safety rules.[2767] Although the precise language of section 224(f)(2) allows electric utilities to deny access for safety, reliability, and engineering concerns, LECs contend they confront the same concerns and need the same authority to deny access when safety or network reliability is jeopardized.[2768]

1134. IXCs argue that nondiscrimination requires an incumbent LEC to provide access on the same terms and conditions that apply to the incumbent LEC or its affiliate.[2769] One IXC suggests that all users of poles and rights-of-way should pay the same rate regardless of the service provided. Under this view, uniform pricing would promote incipient competition.[2770] IXCs contend, however, that access obligations are not reciprocal or symmetrical under section 224. Rather, they contend regulatory asymmetry is required under section 251(b)(4) because that section incorporates section 224 which specifically exempts incumbent LECs from the class of entities entitled to access.[2771]

1135. On capacity questions, IXCs argue strongly for limits on the amount of capacity utilities can reserve for future use. Essentially, they contend the reservation of space, if allowed at all, must be circumscribed by precise standards. For example, a reservation might be allowed

[2764] SBC comments at 18-19.

[2765] Ameritech comments at 38; GTE comments at 25-26; BellSouth comments at 16-17.

[2766] GTE comments at 25-26; Bell Atlantic comments at 14.

[2767] BellSouth comments at 16-17.

[2768] Bell Atlantic comments at 14; Ameritech comments at 38; NYNEX comments at 14.

[2769] MCI comments at 21; Sprint comments at 16.

[2770] Sprint comments at 17-18.

[2771] *See* 47 U.S.C. § 224(a)(5); AT&T reply at 24. One LEC argues, however, that section 251 obligations apply to all LECs, including IXCs if they become LECs within the meaning of the Act. PacTel reply at 23.

for use within a one-year forecast period.[2772] IXCs also contend that claims of insufficient capacity must be scrutinized carefully and that LECs, to the extent they deny access due to capacity constraints, must carry the burden of proving access requests from competitors cannot be accommodated.[2773]

1136. As for safety and reliability concerns, AT&T argues for specific standards to define circumstances under which access can be denied. Whether or not quantifiable standards are adopted, AT&T suggests that the burden of proof should be on utilities to prove they meet applicable standards because utilities or other facility owners, rather than the parties requesting attachments, would have access to information needed to evaluate a particular claim.[2774] Moreover, AT&T argues, under the literal terms of section 224(f)(2), only electric utilities, not incumbent LECs, have explicit authority to justify access denials based on safety, reliability or engineering concerns.[2775]

1137. CAPS favor a literal construction of nondiscrimination, arguing that a loose definition of the term could entice incumbent LECs and utilities to obstruct competition.[2776] Despite recognition that, for the most part, incumbent LECs have been cooperative in allowing access to poles, they contend that on several occasions, LECs and utilities have obstructed such access.[2777] With respect to capacity sufficiency, CAPS agree with LECs that available capacity is a fact-dependent issue, but encourage the Commission to establish standards that would ensure access when existing facilities can be configured to accommodate new telecommunications entrants.[2778] In addition, they support placing the burden of proof to justify denials of access on LECs and utilities subject to an audit of LEC outside plant records.[2779] Similarly, with respect to safety and reliability issues, CAPS advocate the adoption of standards requiring quantifiable threats to safety or reliability before access can be denied.[2780] They, along with the Telecommunications Resellers Association, also favor imposing proof burdens on LECs and

[2772] AT&T comments at 16.

[2773] MCI comments at 23; AT&T comments at 17; Sprint comments at 16-17.

[2774] AT&T comments at 17-18.

[2775] AT&T reply at 11.

[2776] American Communications Services comments at 6.

[2777] American Communications Services comments at 6; GST Telecom comments at 4.

[2778] MFS comments at 10; American Communications Services comments at 7.

[2779] American Communications Services comments at 7; MFS comments at 11.

[2780] MFS comments at 11; GST Telecom comments at 5.

utilities in such cases.[2781] In addition, CAPS support limits on survey or engineering fees that utilities may charge before proceeding with a competitor's attachment or other facility installation.[2782]

1138. Cable operators emphasize that access to poles, conduits and other facilities of LECs and utilities is critical to their ability to compete in the provision of telecommunications services as facilities-based competitors.[2783] Generally, cable operators support a definition of nondiscrimination that ensures that utilities cannot provide access to their facilities that is inferior to that provided to themselves or their affiliates.[2784] Moreover, small cable operators expressed support for the adoption of detailed national rules which they contend will strengthen their ability to negotiate acceptable pole attachment terms.[2785]

1139. With respect to capacity concerns, cable operators urge the Commission to construe narrowly the conditions under which access can be denied based on claims of insufficient capacity. Because access is critical to facilities-based competition, they argue, the Commission should adopt capacity standards that presume the availability of access as long as the new competitor can overcome whatever obstacles stand in the way of making the pole or facility capable of additional attachments.[2786] To underscore the importance of access to facilities-based competition, NCTA notes that Congress explicitly incorporated access to poles, conduits and rights-of-way in both section 251(b)(4) and section 271(c)(2) of the 1996 Act, recognizing that accessibility to such facilities is critical to finding genuine competition in the provision of local exchange service.[2787]

1140. Similarly, with regard to access denials based on claims of safety, reliability or engineering concerns, cable operators support using the NESC as the benchmark for resolving disputes over such issues. To the degree factors or standards other than those set forth in the NESC are relied upon to justify access, cable operators support a presumption that such denials are unreasonable and support the imposition of proof burdens on any LEC or utility making such

[2781] MFS comments at 11; GST Telecom comments at 5; Telecommunications Resellers Assn. comments at 13.

[2782] MFS comments at 11; GST Telecom comments at 6.

[2783] NCTA comments at 3-4.

[2784] Cole comments at 18.

[2785] Small Cable Business Association Comments at 21.

[2786] Summit comments at 1; Cole comments at 17.

[2787] NCTA comments at 12.

claims.[2788]

1141. In their comments, state commissions emphasize their experience in dealing with pole attachment issues. One state commission indicates that its procedures for handling disputes concerning access to poles, conduits, and rights-of-way are sufficient and that any changes in procedures are unnecessary at this time.[2789] Moreover, state Commissions emphasize that the statute itself recognizes the prominent role of state and local regulation in the area of pole attachments, citing the preservation of state preemption of federal rules when a state has regulated in this area.[2790]

1142. With respect to the definition of nondiscrimination, state commissions urge us to ensure that incumbent LECs provide access to poles and other facilities on terms that do not discriminate unreasonably between similarly situated carriers.[2791] The Ohio Consumers' Counsel agrees, suggesting that nondiscrimination requires that LECs provide competitors access on the same terms it provides to itself or its affiliates.[2792] As for the various reasons that may be asserted to justify denial of access, the Ohio Commission and Ohio Consumers' Counsel argue that a heavy burden should be placed on the LEC or utility denying access to demonstrate whenever capacity constraints, safety issues or reliability concerns are claimed for the access denial.[2793]

c. Discussion

(1) Generally

1143. We conclude that the reasonableness of particular conditions of access imposed by a utility should be resolved on a case-specific basis. We discuss below the forum for such resolutions.[2794] The record makes clear that there are simply too many variables to permit any other approach with respect to access to the millions of utility poles and untold miles of conduit

[2788] NCTA comments at 12; Cole comments at 18.

[2789] Illinois Commission comments at 72.

[2790] District of Columbia Commission comments at 9.

[2791] Illinois Commission comments at 73-74; Texas Commission comments at 3; California Commission comments at 5.

[2792] Ohio Consumers' Counsel comments at 5-6.

[2793] Ohio Commission comments at 11-12; Ohio Consumers' Counsel comments at 5-6.

[2794] *See infra*, Section E.

in the nation.[2795] The broader access mandated by the Act, in conjunction with the reasonableness variables mentioned here, will likely increase the number of disputes over access. In turn, this may cause small incumbent LECs and small entities to incur the need for additional resources to evaluate, process, and resolve such disputes, as well as to make poles and conduits physically accessible.[2796] We will not enumerate a comprehensive regime of specific rules, but instead establish a few rules supplemented by certain guidelines and presumptions that we believe will facilitate the negotiation and mutual performance of fair, pro-competitive access agreements. We will monitor the effect of this approach and propose more specific rules at a later date if reasonably necessary to facilitate access and the development of competition in telecommunications and cable services. We believe that the rules, guidelines and presumptions established herein strike the appropriate balance between the need for uniformity, on the one hand, and the need for flexibility, on the other, which should minimize the regulatory burdens and economic impact for both small entities and small incumbent LECs.[2797]

1144. We also address the impact on small incumbent LECs. For example, the Rural Telephone Coalition opposes adoption of sweeping national rules because local circumstances will be relevant to disputes over access to poles or rights-of-way.[2798] We have considered the economic impact of our rules in this section on small incumbent LECs. For example, we have adopted a flexible regulatory approach to pole attachment disputes that ensures consideration of local conditions and circumstances.

1145. Our determination not to prescribe numerous specific rules is supported by acknowledgements in the relevant national industry codes that no single set of rules can take into account all of the issues that can arise in the context of a single installation or attachment. The NESC, one of the national codes that virtually all commenters regard as containing reasonable attachment requirements, contains thousands of rules and dozens of tables and figures, all designed to ensure "the practical safeguarding of persons during the installation, operation, or maintenance of electric supply and communication lines and associated equipment."[2799]

1146. For example, with respect to overhead wires, the NESC contains 64 pages of rules dictating minimum "clearances," i.e., the minimum separations between a particular wire, cable,

[2795] Delmarva comments at 6.

[2796] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2797] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2798] RTC comments at 14.

[2799] NESC § 010.

or other piece of equipment and other wires, cables, equipment, structures, and property.[2800] A short list of only a few of the variables in that discussion includes: the type of wire or equipment in question; the type of current being transmitted; the nature of the structure supporting the wires; the proximity and nature of other equipment and structures; the temperature of the conducting element; and the use of the land below the wires. These separation requirements dictate the required distances between various wires and other transmission and distribution equipment, as well distances between such equipment and other objects that are not a part of the transmission and distribution network. Prescribed separations between wires will vary between the point at which wires are attached to a pole and at mid-points between poles, with the latter separations dictated by the predicted amount of sag that the wires will experience. The amount of sag will itself depend upon additional variables. Changing just one variable can radically alter the separation requirements.[2801] Other rules dictate: electrical loading requirements that vary depending upon wind and ice conditions and the predicted sag of the lines being installed; structural strength requirements that vary depending upon the amount and type of installations an the nature of the supporting structure; and line insulation requirements. A wholly separate and equally extensive array of rules apply to underground lines.

1147. Despite this specificity, the introduction to the NESC states that the code "is not intended as a design specification or an instruction manual."[2802] Indeed, utilities typically impose requirements more stringent than those prescribed by NESC and other industry codes.[2803] In some cases stricter requirements and restrictions are dictated by federal, state, or local law.[2804] Potentially applicable federal regulations include rules promulgated by the Federal Energy Regulatory Commission ("FERC") and by the Occupational Safety and Health Administration ("OSHA").[2805] Various restrictions can apply at the state level as well.[2806] Some local requirements governing zoning, aesthetics, or road clearances impose more stringent or more

[2800] NESC § 23.

[2801] For example, depending upon other conditions there are at least 16 potentially applicable clearance requirements relating specifically to wires passing over or near swimming pools. Separate sets of clearance requirements apply to wires in the vicinity of rail cars, and for wires attached near bridges.

[2802] NESC § 010.

[2803] NU comments at 4-5; BellSouth comments at 16-17; Virginia Electric comments at 10-12; Carolina comments at 4; NEES comments at 11.

[2804] NEES comments at 6, 11; PECO comments at 2; Duquesne comments at 11-12; Virginia comments at 11-12

[2805] Texas Commission comments at 4; NEES comments at 11; American Electric comments at 25. *See* 29 C.F.R. §§ 1910.268, 1910.269.

[2806] NEES comments at 6 (*citing* Massachusetts statute prohibiting electric utilities from permitting attachments to their transmission facilities); Duquesne comments at 11-12 (describing similar restriction under Wisconsin law).

specific requirements than those of the national industry codes or of federal or state law.[2807]

1148. In addition to operating under federal, state, and local requirements, a utility normally will have its own operating standards that dictate conditions of access.[2808] Utilities have developed their own individual standards and incorporated them into pole attachment agreements because industry-wide standards and applicable legal requirements are too general to take into account all of the variables that can arise.[2809] A utility's individual standards cover not simply its policy with respect to attachments, but all aspects of its business. Standards vary between companies and across different regions of the country based on the experiences of each utility and on local conditions.[2810] As Duquesne notes, the provision of electricity is the result of varied engineering factors that continue to evolve.[2811] Because there is no fixed manner in which to provide electricity, there is no way to develop an exhaustive list of specific safety and reliability standards.[2812] In addition, increasing competition in the provision of electricity is forcing electric utilities to engineer their systems more precisely, in a way that is tailored to meet the specific needs of the electric company and its customers.[2813] As a result, each utility has developed its own internal operating standards to suit its individual needs and experiences.[2814]

1149. The record contains numerous factors that may vary from region to region, necessitating different operating procedures particularly with respect to attachments. Extreme temperatures, ice and snow accumulation, wind, and other weather conditions all affect a utility's safety and engineering practices.[2815] In some instances, machinery used by local industries requires higher than normal clearances. Particular utility work methods and equipment may require specific separations between attachments and may restrict the height of the poles that a

[2807] American Electric comments at 36; Delmarva comments at 10-11; Ameritech comments at 38; PECO comments at 2.; Duquesne comments at 11-13; ConEd comments at 11.

[2808] American comments at 26, 36; NEES comments at 11.

[2809] Virginia Power comments at 13; NEES comment at 11; NU comments at 4-5.

[2810] ConEd comments at 5; Duquesne comments at 7; NEES comments at 11.

[2811] Duquesne comments at 21.

[2812] *Id.*; UTC reply at 20.

[2813] Duquesne comments at 21.

[2814] ConEd reply at 2.

[2815] NEES comments at 11; Carolina comments at 4; American Electric comments at 31.

utility will use.[2816] The installation and maintenance of underground facilities raise distinct safety and reliability concerns.[2817] It is important that such variables be taken into account when drafting pole attachment agreements and considering an individual attachment request. The number of variables makes it impossible to identify and account for them all for purposes of prescribing uniform standards and requirements.[2818] Universally accepted codes such as the NESC do not attempt to prescribe specific requirements applicable to each attachment request and neither shall we.

1150. We are sensitive to concerns of cable operators and telecommunications carriers regarding utility-imposed restrictions that could be used unreasonably to prevent access.[2819] We note in particular that a utility that itself is engaged in video programming or telecommunications services has the ability and the incentive to use its control over distribution facilities to its own competitive advantage. A number of utilities have obtained, or are seeking, the right and ability to provide telecommunications or video programming services.[2820] We agree, however, with Duquesne that the best safeguard is not the adoption of a comprehensive set of substantive engineering standards, but the establishment of procedures that will require utilities to justify any conditions they place on access.[2821] These procedures are outlined in section E below. In the next two sections, we set forth rules of general applicability and broader guidelines relating to specific issues that are intended to govern access negotiations between the parties.

(2) Specific Rules

1151. We establish five rules of general applicability. First, in evaluating a request for access, a utility may continue to rely on such codes as the NESC to prescribe standards with respect to capacity, safety, reliability, and general engineering principles. We have no reason to question the reasonableness of the virtually unanimous judgment of the commenters, many of whom have otherwise diverse and conflicting interests, in this regard.[2822] Utilities may incorporate such standards into their pole attachment agreements in accordance with section

[2816] American Electric comments at 20; NEES comments at 11; Carolina comments at 4.

[2817] ConEd comments at 7; Kansas City comments at 3-4; UTC reply at 20.

[2818] American Electric comments at 18-20, 36; Delmarva reply at 7-8.

[2819] Cole comments 3-7.

[2820] Cole reply at 3-7.

[2821] Duquesne comments at 21.

[2822] Cole comments at 22; American Electric comments at 22; NCTA reply at 6-7; UTC reply at 15-16; Virginia Power reply at 6; Ohio Edison reply at 23-24.

224(f)(2). Other industry codes also will be presumed reasonable if shown to be widely-accepted objective guides for the installation and maintenance of electrical and communications facilities.

1152. Second, federal requirements, such as those imposed by FERC and OSHA, will continue to apply to utilities to the extent such requirements affect requests for attachments to utility facilities under section 224(f)(1). We see no reason to supplant or modify applicable federal regulations promulgated by FERC, OSHA, or other federal agencies acting in accordance with their lawful authority.

1153. Third, we will consider state and local requirements affecting pole attachments. We note that section 224(c)(1) provides:

> Nothing in this section shall be construed to apply to, or to give the Commission jurisdiction with respect to rates, terms and conditions, or access to poles, ducts, conduits, and rights-of-way as provided in subsection (f), for pole attachments in any case where such matters are regulated by the State.[2823]

1154. In a separate section we discuss the authority of a state to preempt federal regulation of pole attachments.[2824] For present purposes, we conclude that state and local requirements affecting attachments are entitled to deference even if the state has not sought to preempt federal regulations under section 224(c).[2825] The 1996 Act increased significantly the Commission's role with respect to attachments by creating federal access rights and obligations, which for decades had been the subject of state and local regulation. Such regulations often relate to matters of local concern that are within the knowledge of local authorities and are not addressed by standard codes such the NESC.[2826] We do not believe that regulations of this sort necessarily conflict with the scheme established in this Order. More specifically, we see nothing in the statute or in the record that compels us to preempt such local regulations as a matter of course. Regulated entities and other interested parties are familiar with existing state and local requirements and have adopted operating procedures and practices in reliance on those requirements. We believe it would be unduly disruptive to invalidate summarily all such local requirements. We thus agree with commenters who suggest that such state and local requirements should be presumed reasonable.[2827] Thus, even where a state has not asserted preemptive authority in accordance with section 224(c), state and local requirements affecting pole

[2823] 47 U.S.C. § 224(c)(1).

[2824] *See infra*, Section E.

[2825] New Mexico comments at 12; Ohio comments at 11.

[2826] *See supra*, Section B.2.

[2827] PECO comments at 2; Kansas City comments at 2-3; NEES reply at 13.

attachments remain applicable, unless a complainant can show a direct conflict with federal policy. Where a local requirement directly conflicts with a rule or guideline we adopt herein, our rules will prevail. We note that a standard prescribed by the NESC is not a specific Commission rule, and therefore a state requirement that is more restrictive than the corresponding NESC standard may still apply.

1155. It is important to note that the discretion of state and local authorities to regulate in the area of pole attachments is tempered by section 253, which invalidates all state or local legal requirements that "prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service."[2828] This restriction does not prohibit a state from imposing "on a competitively neutral basis and consistent with section 254, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers."[2829] In addition, section 253 specifically recognizes the authority of state and local governments to manage public rights-of-way and to require fair and reasonable compensation for the use of such rights-of-way.[2830]

1156. Fourth, where access is mandated, the rates, terms, and conditions of access must be uniformly applied to all telecommunications carriers and cable operators that have or seek access.[2831] Except as specifically provided herein, the utility must charge all parties an attachment rate that does not exceed the maximum amount permitted by the formula we have devised for such use, and that we will revise from time to time as necessary.[2832] Other terms and conditions also must be applied on a nondiscriminatory basis.[2833]

1157. Fifth, except as specifically noted below, a utility may not favor itself over other parties with respect to the provision of telecommunications or video programming services.[2834] We interpret the statutory requirement of nondiscriminatory access as compelling this result, particularly when read in the context of other provisions of the statute. This element of

[2828] 47 U.S.C. § 253(a).

[2829] 47 U.S.C. § 253(b); section 254 sets forth specific provisions related to universal service.

[2830] 47 U.S.C. § 253(c). *See* Ameritech reply at 10.

[2831] 47 U.S.C. § 224(f)(1). As noted above, incumbent LECs are excluded from the definition of "telecommunications carrier" for purposes of section 224. 47 U.S.C. § 224(a)(5).

[2832] *See* 47 C.F.R. § 1.1404.

[2833] *See supra*, Sections IV.G. and V.G. for a discussion of the meaning of "nondiscriminatory."

[2834] 47 U.S.C. § 224(f)(1); *see* Ohio Consumers' Counsel comments at 5; California comments at 5; MCI comments at 21; Sprint comments at 16; ACSI comments at 6-7.

nondiscrimination is evident in section 224(g), which requires a utility to impute to itself or to its affiliate the pole attachment rate such entity would be charged were it a non-affiliated entity.[2835] Further, we believe it unlikely that Congress intended to allow an incumbent LEC to favor itself over its competitors with respect to attachments to the incumbent LEC's facilities, given that section 224(a)(5) has just the opposite effect in that it operates to preclude the incumbent LEC from obtaining access to the facilities of other LECs. A utility will be able to discriminate in favor of itself with respect to the provision of telecommunications or cable services only as expressly provided herein.

1158. Aside from the conditions described above, we will not adopt specific rules to determine when access may be denied because of capacity, safety, reliability, or engineering concerns. In addition, we reject the contention of some utilities that they are the primary arbiters of such concerns, or that their determinations should be presumed reasonable.[2836] We recognize that the public welfare depends upon safe and reliable provision of utility services, yet we also note that the 1996 Act reinforces the vital role of telecommunications and cable services. As noted above, section 224(f)(1) in particular reflects Congress' intention that utilities must be prepared to accommodate requests for attachments by telecommunications carriers and cable operators.

(3) Guidelines Governing Certain Issues

1159. In addition to the rules articulated above, we will establish guidelines concerning particular issues that have been raised in this proceeding. These guidelines are intended to provide general ground rules upon which we expect the parties to be able to implement pro-competitive attachment polices and procedures through arms-length negotiations, rather than having to rely on multiple adjudications by the Commission in response to complaints or by other forums. We do not discuss herein every issue raised in the comments. Rather, we discuss only major issues that we believe will arise often. Issues not discussed herein may be important in a particular case, but are not susceptible to any general observation or presumption.

1160. We note that a utility's obligation to permit access under section 224(f) does not depend upon the execution of a formal written attachment agreement with the party seeking access. We understand that such agreements are the norm and encourage their continued use, subject to the requirements of section 224. Complaint or arbitration procedures will, of course, be available when parties are unable to negotiate agreements.[2837]

[2835] 47 U.S.C. § 224(g).

[2836] American Electric comments at 14, 21; NEES comments at 14; ConEd comments at 11; Delmarva reply at 8.

[2837] *See infra*, Section E.

(a) Capacity Expansions

1161. When a utility cannot accommodate a request for access because the facility in question has no available space, it often must modify the facility to increase its capacity.[2838] In some cases, a request for access can be accommodated by rearranging existing facilities to make room for a new attachment.[2839] Another method of maximizing useable capacity is to permit "overlashing," by which a new cable is wrapped around an existing wire, rather than being strung separately.[2840] A utility pole filled to capacity often can be replaced with a taller pole.[2841] New underground installations can be accommodated by the installation of new duct, including subducts that divide a standard duct into four separate, smaller ducts.[2842] Cable companies and others contend that there is rarely a lack of capacity given the availability of taller poles and additional conduits.[2843] These commenters suggest that utilities should rarely be permitted to deny access on the basis of a lack of capacity, particularly since under section 224(h) the party or parties seeking to increase capacity will be responsible for all associated costs.[2844] Utilities argue that neither the statute nor its legislative history requires facility owners to expand or alter their facilities to accommodate entities seeking to lease space.[2845] These commenters argue that, if Congress intended such a result, the statute would have imposed the requirement explicitly.[2846]

1162. A utility is able to take the steps necessary to expand capacity if its own needs require such expansion. The principle of nondiscrimination established by section 224(f)(1) requires that it do likewise for telecommunications carriers and cable operators.[2847] In addition, we note that section 224(f)(1) mandates access not only to physical utility facilities (*i.e.*, poles,

---

[2838] Cole comments at 9; ConEd comments at 10; MFS comments at 10; NCTA reply at 5-6.

[2839] GST Telecom comments at 5.

[2840] MFS comments at 10; GST Telecom comments at 5.

[2841] Cole comments at 14-15.

[2842] GST Telecom comments at 5; Cole comments at 17.

[2843] Cole comments at 15.

[2844] NCTA comments at 12; Summit comments at 1; MCI comments at 23.

[2845] American Electric reply at 19; ConEd reply at 5; U S West reply at 7; GTE reply at 26; Virginia Power reply at 5.

[2846] SBC reply at 21.

[2847] AT&T reply at 14-15; MFS reply at 22. We note that this standard differs from the one we adopt for collocation of equipment on incumbent LEC premises under section 251(c)(6). *See supra*, Section VI.

ducts, and conduit), but also to the rights-of-way held by the utility. The lack of capacity on a particular facility does not necessarily mean there is no capacity in the underlying right-of-way that the utility controls. For these reasons, we agree with commenters who argue that a lack of capacity on a particular facility does not automatically entitle a utility to deny a request for access. Since the modification costs will be borne only by the parties directly benefitting from the modification,[2848] neither the utility nor its ratepayers will be harmed, despite the assertions of utilities to the contrary.[2849]

1163. In some cases, however, increasing capacity involves more than rearranging existing attachments or installing a new pole or duct. For example, the record suggests that utility poles of 35 and 40 feet in height are relatively standard, but that taller poles may not always be readily available.[2850] The transportation, installation, and maintenance of taller poles can entail different and more costly practices.[2851] Many utilities have trucks and other service equipment designed to maintain poles of up to 45 feet, but no higher.[2852] Installing a 50 foot pole may require the utility to invest in new and costly service equipment.[2853] Expansion of underground conduit space entails a very complicated procedure, given the heightened safety and reliability concerns associated with such facilities.[2854] Local regulators may seek to restrict the frequency of underground excavations. We find it inadvisable to attempt to craft a specific rule that prescribes the circumstances in which, on the one hand, a utility must replace or expand an existing facility in response to a request for access and, on the other hand, it is reasonable for the utility to deny the request due to the difficulties involved in honoring the request. We interpret sections 224(f)(1) and (f)(2) to require utilities to take all reasonable steps to accommodate requests for access in these situations. Before denying access based on a lack of capacity, a utility must explore potential accommodations in good faith with the party seeking access.

1164. We will not require telecommunications providers or cable operators seeking access to exhaust any possibility of leasing capacity from other providers, such as through a resale

---

[2848] *See infra*, Section 2(b).

[2849] *See, e.g.*, Ohio Ed reply at 19.

[2850] NEES comments at 8; Cole comments at 15.

[2851] Carolina comments at 3-4; American Electric comments at 23.

[2852] NEES comments at 8-9.

[2853] UTC reply at 17.

[2854] American Electric comments at 20, 31; ConEd comments at 7; Kansas City comments at 3-4; UTC comments at 18. Some commenters assert that expanding conduit capacity is impractical. Delmarva reply at 7.

agreement, before requesting a modification to expand capacity.[2855] As indicated elsewhere in this Order, resale will play an important role in the development of competition in telecommunications. However, as we also have noted, there are benefits to facilities-based competition as well. We do not wish to discourage unduly the latter form of competition solely because the former might better suit the preferences of incumbent utilities with respect to pole attachments.

(b) Reservation of space by utility

1165. Utilities routinely reserve space on their facilities to meet future needs.[2856] Local economic growth and property development may require an electric utility to install additional lines or transformers that use previously available space on the pole.[2857] A utility may install an underground duct in which it can later install additional distribution lines, if necessitated by a subsequent increase in demand or by damage to the original lines.[2858] Reserving space allows the utility to respond quickly and efficiently to changed circumstances. This practice, however, also can result in a utility denying access to a telecommunications carrier or a cable operator even though there is unused capacity on the pole or duct.

1166. This issue is of particular concern because section 224(h) imposes the cost of modifying attachments on those parties that benefit from the modification.[2859] If, for example, a cable operator seeks to make an attachment on a facility that has no available capacity, the operator would bear the full cost of modifying the facility to create new capacity, such as by replacing an existing pole with a taller pole. Other parties with attachments would not share in the cost, unless they expanded their own use of the facilities at the same time. If the electric utility decides to change a pole for its own benefit, and no other parties derive a benefit from the modification, then the electric company would bear the full cost of the new pole.

1167. Some commenters contend that utilities will reserve space on a pole and then claim there is no capacity available, as a way of forcing cable operators and telecommunications carriers to pay for new utility facilities. These commenters contend that we should restrict or eliminate

[2855] *See* PNM comments at 20; Carolina comments at 5; American Electric reply at 14.

[2856] American Electric comments at 43; UTC reply at 22.

[2857] Virginia Power comments at 8; American comments at 23; Connecticut Light comments at 5.

[2858] Ohio Edison comments at 16-17; ConEd comments at 9.; Delmarva reply at 5.

[2859] *See infra*, Section (C)(3).

the authority of utilities to reserve space.[2860] Utilities respond that it is unfair to force a utility to accommodate full occupation of its facility by third parties and then to saddle the utility with the cost of modifying the facility when the utility's own needs change and require a costly increase in capacity.[2861]

1168. The near-universal public demand for their core utility services, while imposing certain obligations, arguably entitles utilities to certain prerogatives vis-a-vis other parties, including the right to reserve capacity to meet anticipated future demand for those utility services.[2862] Recognition of such a right, however, could conflict with the nondiscrimination requirement of section 224(f)(1) which prohibits a utility from favoring itself or its affiliates with respect to the provision of telecommunications and video services.[2863] In addition, allowing space to go unused when a cable operator or telecommunications carrier could make use of it is directly contrary to the goals of Congress.

1169. Balancing these concerns leads us to the following conclusions. We will permit an electric utility to reserve space if such reservation is consistent with a bona fide development plan that reasonably and specifically projects a need for that space in the provision of its core utility service. The electric utility must permit use of its reserved space by cable operators and telecommunication carriers until such time as the utility has an actual need for that space. At that time, the utility may recover the reserved space for its own use. The utility shall give the displaced cable operator or telecommunications carrier the opportunity to pay for the cost of any modifications needed to expand capacity and to continue to maintain its attachment.[2864] An electric utility may not reserve or recover reserved space to provide telecommunications or video programming service and then force a previous attaching party to incur the cost of modifying the facility to increase capacity, even if the reservation of space were pursuant to a reasonable development plan. The record does not contain sufficient data for us to establish a presumptively reasonable amount of pole or conduit space subject that an electric utility may reserve. If parties cannot agree, disputes will be resolved on a case-by-case approach based on the reasonableness of the utility's forecast of its future needs and any additional information that is relevant under the circumstances.

[2860] MCI comments at 23; ACSI comments at 6-8; MFS comments at 7; Time Warner comments at 14; AT&T reply at 14-15.

[2861] AEP comments at 42-43; Duquesne comments at 17; PECO comments at 7; Delmarva comments at 14.

[2862] PNM comments at 8-9; American Electric comments at 13; ConEd reply at 4-5.

[2863] Ohio Consumers Counsel comments at 5-6; Delmarva comments at 8.

[2864] This standard differs from the one we adopt for allocation of collocation space under section 251(c)(4). *See supra*, Section VI.

1170. With respect to a utility providing telecommunications or video services, we believe the statute requires a different result. Section 224(f)(1) requires nondiscriminatory treatment of all providers of such services and does not contain an exception for the benefit of such a provider on account of its ownership or control of the facility or right-of-way. Congress seemed to perceive such ownership and control as a threat to the development of competition in these areas, thus leading to the enactment of the provision in question. Allowing the pole or conduit owner to favor itself or its affiliate with respect to the provision of telecommunications or video services would nullify, to a great extent, the nondiscrimination that Congress required. Permitting an incumbent LEC, for example, to reserve space for local exchange service, to the detriment of a would-be entrant into the local exchange business, would favor the future needs of the incumbent LEC over the current needs of the new LEC. Section 224(f)(1) prohibits such discrimination among telecommunications carriers. As indicated above, this prohibition does not apply when an electric utility asserts a future need for capacity for electric service, to the detriment of a telecommunications carrier's needs, since the statute does not require nondiscriminatory treatment of all utilities; rather, it requires nondiscriminatory treatment of all telecommunications and video providers.

(c) Definition of "Utility"

1171. The access obligations of section 224(f) apply to any "utility," which is defined as:

> any person who is a local exchange carrier or an electric, gas, water, steam, or other public utility, and who owns or controls poles, ducts, conduits, or other rights-of-way used, in whole or in part, for any wire communications. Such term does not include any railroad, any person who is cooperatively organized, or any person owned by the Federal Government or any State.[2865]

1172. Arguably a provider of utility service does not fall within this definition if it has refused to permit any wired communications use of its facilities and rights-of-way since, in that case, its facilities and rights-of-way are not "used, in whole or in part, for wire communications." Under this construction, an electric utility would have no obligation to grant access under section 224(f) until the utility voluntarily has granted access to one communications provider or has used its facilities for wire communications.[2866] Only after its facilities were being used for wire communications would the utility have to grant access to all telecommunications carriers and cable operators on a nondiscriminatory basis.

1173. We conclude that this construction of the statute is mandated by its plain language

[2865] 47 U.S.C. § 224(a)(1).

[2866] NU Systems comments at 2-3; UTC comments at 6-7.

and is indeed nondiscriminatory, since denial of access to all discriminates against none. We see no statutory basis, however, for the argument made by some utilities that they should be permitted to devote a portion of their poles, ducts, conduits, and rights-of-way to wire communications without subjecting all such property to the access obligations of section 224(f)(1).[2867] Those obligations apply to any "utility," which section 224(a)(1) defines to include an entity that controls "poles, ducts, conduits, or rights-of-way used, in whole or in part, for any wire communications."[2868] The use of the phrase "in whole or in part" demonstrates that Congress did not intend for a utility to be able to restrict access to the exact path used by the utility for wire communications. We further conclude that use of any utility pole, duct, conduit, or right-of-way for wire communications triggers access to all poles, ducts, conduits, and rights-of-way owned or controlled by the utility, including those not currently used for wire communications.

1174. We reject the contention that, because an electric utility's internal communications do not pose a competitive threat to third party cable operators or telecommunications carriers, such internal communications are not "wire communications" and do not trigger access obligations.[2869] Although internal communications are used solely to promote the efficient distribution of electricity, the definition of "wire communication" is broad and clearly encompasses an electric utility's internal communications.[2870]

(d) Application of Section 224(f)(2) to Non-Electric Utilities

1175. While all utilities are subject to the access obligations of section 224(f)(1), the provisions of section 224(f)(2), permitting a utility to deny access due to a lack of capacity or for reasons of safety, reliability, and generally applicable engineering purposes, apply only to "a utility providing electric service . . . ."[2871] Based on this statutory language, some commenters suggest that LECs and other utilities that do not provide electric service must grant requests for access, regardless of any concerns relating to safety, reliability, and general engineering principles.[2872] If there is a lack of capacity, a LEC must create more capacity, according to these

[2867] *See* American Electric comments at 12, n. 7.

[2868] 47 U.S.C. § 224(a)(1).

[2869] *See* UTC comments at 7; Delmarva reply at 5.

[2870] *See* 47 U.S.C. 3(51) ("The term 'wire communication" . . . means the transmission of writing, signs, signals, pictures, and sounds of all kinds by aid of wire, cable, or other like connection . . .").

[2871] 47 U.S.C. § 224(f)(2).

[2872] *See, e.g.*, AT& T comments at 16-17.

commenters.[2873]

1176. While the express language of sections 224(f)(1) and (f)(2) suggests that only utilities providing electric service can take into consideration concerns relating to safety and reliability, we are reluctant to ignore these concerns simply because the pole owner is not an electric utility. Even parties seeking broad access rights under section 224 recognize that, in some circumstances, a LEC will have legitimate safety or engineering concerns that may need to be accommodated.[2874] We believe that Congress could not have intended for a telecommunications carrier to ignore safety concerns when making pole attachment decisions. Rather than reach this dangerous result which would require us to ignore the dictates of sections 1[2875] and 4(o)[2876] of the Communications Act, we conclude that any utility may take into account issues of capacity, safety, reliability and engineering when considering attachment requests, provided the assessment of such factors is done in a nondiscriminatory manner.

1177. Nevertheless, we believe that section 224(f)(2) reflected Congress' acknowledgment that issues involving capacity, safety, reliability and engineering raise heightened concerns when electricity is involved, because electricity is inherently more dangerous than telecommunications services. Accordingly, although we determine that it is proper for non-electric utilities to raise these matters, they will be scrutinized very carefully, particularly when the parties concerned have a competitive relationship.

(e) Third-Party Property Owners

1178. Section 224(f)(1) mandates that the utility grant access to any pole, duct, conduit, or right-of-way that is "owned or controlled by it." Some utilities and LECs argue that certain private easement agreements, when interpreted under the applicable state property laws, deprive the utilities of the ownership or control that triggers their obligation to accommodate a request for access.[2877] Moreover, they contend, access to public rights-of-way may be restricted by state law

[2873] *Id.* at 16-17.

[2874] AT&T reply at 17, n. 40

[2875] 47 U.S.C. § 151 (establishing the Commission for the purpose of promoting a "rapid, efficient Nation-wide, and world-wide wire and radio and communication service with adequate facilities . . . [and] promoting safety of life and property . . .").

[2876] 47 U.S.C. § 154 (o) (promoting the "safety of life and property" with respect to the use of radio and wire communications).

[2877] UTC comments at 7-8; GVNW comments at 9; U S West reply at 6; BellSouth reply at 9; *see* BOMA reply at 3.

or local ordinances.[2878] Opposing commenters contend that the addition of cable television or telecommunications facilities is compatible with electric service and therefore does not violate easements that have been granted for the provision of electric service.[2879] These commenters also assert that the statute does not draw specific distinctions between private and public easements.[2880] Further, some cable operators contend that utility easements are accessible to cable operators pursuant to section 621(a)(2) of the Communications Act as long as the easements are physically compatible with such use, regardless of the terms of a written easement agreement.[2881] Another commenter suggests utilities are best positioned to determine when access requests would affect a private easement, foreclosing the need to determine whether a private owner would consent to the requested attachment.[2882] As for local ordinances restricting access to public rights-of-way, one commenter suggests that such restrictions would violate section 253(a) of the Act, which blocks state or local rules that prohibit competition.[2883]

1179. The scope of a utility's ownership or control of an easement or right-of-way is a matter of state law.[2884] We cannot structure general access requirements where the resolution of conflicting claims as to a utility's control or ownership depends upon variables that cannot now be ascertained. We reiterate that the access obligations of section 224(f) apply when, as a matter of state law, the utility owns or controls the right-of-way to the extent necessary to permit such access.

1180. Section 621(a)(2) states that a cable franchise shall be construed as authorizing the construction of cable facilities in public rights-of-way and "through easements . . . which have been dedicated for compatible uses . . . ."[2885] The scope of a cable operator's access to easements under this provision has been the subject of a number of court opinions.[2886] To the extent section

[2878] Rural Tel. reply at 4.

[2879] Cole comments at 16-17.

[2880] MFS reply at 16.

[2881] Cole comments at 17; *see* 47 U.S.C. § 541(a)(2).

[2882] AT&T reply at 18.

[2883] Sprint reply at 18.

[2884] *See* S. Rep. No. 580, 95th Cong., 1st Sess. 16 (1977).

[2885] 47 U.S.C. § 541(a)(2).

[2886] *TCI of North Dakota, Inc. v. Schriock Holding Co.*, 11 F.3d 812 (8th Cir. 1993); *Media General Cable of Fairfax, Inc. v. Sequoyah Condominium Council of Co-Owners*, 991 F.2d 1169 (4th Cir. 1993); *Cable Holdings of Georgia, Inc. v. McNeil Real Estate Fund VI, Ltd.*, 953 F.2d 600 (11th Cir.), *cert. den'd*, 506 U.S. 862 (1992); *Cable*

621(a)(2) has been construed to permit access to easements, a cable operator must be permitted to attach to utility poles, ducts, and conduits within such easements in accordance with section 224(f).

1181. Finally, we disagree with those utilities that contend that they should not be forced to exercise their powers of eminent domain to establish new rights-of-way for the benefit of third parties.[2887] We believe a utility should be expected to exercise its eminent domain authority to expand an existing right-of-way over private property in order to accommodate a request for access, just as it would be required to modify its poles or conduits to permit attachments. Congress seems to have contemplated an exercise of eminent domain authority in such cases when it made provisions for an owner of a right-of-way that "intends to modify or alter such . . . right-of-way . . . ."[2888]

(f) Other Matters

1182. Utilities stress the importance of ensuring that only qualified workers be permitted in the proximity of utility facilities. Some utilities seek to limit access to their facilities to the utility's own specially trained employees or contractors, particularly with respect to underground conduits.[2889] According to these commenters, parties seeking to make attachments to utility facilities should be required to pay for the use of the utility's workers if the utility concludes that only its workers are fit for the job. While we agree that utilities should be able to require that only properly trained persons work in the proximity of the utilities' lines, we will not require parties seeking to make attachments to use the individual employees or contractors hired or pre-designated by the utility. A utility may require that individuals who will work in the proximity of electric lines have the same qualifications, in terms of training, as the utility's own workers, but the party seeking access will be able to use any individual workers who meet these criteria. Allowing a utility to dictate that only specific employees or contractors be used would impede the access that Congress sought to bestow on telecommunications providers and cable operators and would inevitably lead to disputes over rates to be paid to the workers.

1183. Some electric utilities argue that high voltage transmission facilities should not be accessible by telecommunications carriers or cable operators under section 224(f)(1).[2890] These commenters contend that transmission facilities, which are used for high voltage transmissions

---

Investments, Inc. v. Woolley, 867 F.2d 151 (3d Cir. 1989).

[2887] *But see* UTC comments at 15; Ohio Edison comments at 14-15.

[2888] 47 U.S.C. § 224(h).

[2889] Kansas City at 3-4.

[2890] NEES comments at 15-16; PECO comments at 4.

over great distances, are far more delicate and dangerous than local distribution facilities. Permitting attachments to transmission facilities, they argue, poses a greater risk to the safety and reliability of the electric distribution system than is the case with distribution lines. They further state that transmission facilities generally are not located where cable operators and telecommunications carriers need to install facilities. ConEd suggests that transmission towers do not even fall within the scope of the statute.[2891]

1184. Section 224(f)(1) mandates access to "any pole, duct, conduit, or right-of-way," owned or controlled by the utility. The utilities do not suggest that transmission facilities do not use poles or rights-of-way, for which the statute does mandate the right of access. The utilities' arguments for excepting transmission facilities from access requirements are based on safety and reliability concerns. We believe that the breadth of the language contained in section 224(f)(1) precludes us from making a blanket determination that Congress did not intend to include transmission facilities. As with any facility to which access is sought, however, section 224(f)(2) permits the electric utility to impose conditions on access to transmission facilities, if necessary for reasons of safety and reliability. To the extent safety and reliability concerns are greater at a transmission facility, the statute permits a utility to impose stricter conditions on any grant of access or, in appropriate circumstances, to deny access if legitimate safety or reliability concerns cannot be reasonably accommodated.[2892]

1185. We note that some commenters favor a broad interpretation of "pole, duct, conduit, or right-of-way" because that approach would minimize the risk that a "pathway" vital to competition could be shut off to new competitors.[2893] Others argue for a narrow construction of this statutory phrase, contending that Congress addressed access to other LEC facilities elsewhere in the 1996 Act.[2894] We recognize that an overly broad interpretation of this phrase could impact the owners and mangers of small buildings, as well as small incumbent LECs, by requiring additional resources to effectively control and monitor such rights-of-way located on their properties.[2895] We do not believe that section 224(f)(1) mandates that a utility make space available on the roof of its corporate offices for the installation of a telecommunications carrier's transmission tower,[2896] although access of this nature might be mandated pursuant to a request for

---

[2891] ConEd comments at 6.

[2892] 47 U.S.C. § 224(f)(2).

[2893] AT&T comments at 14.

[2894] Ameritech reply at 8; NYNEX reply at 8; PacTel reply at 22.

[2895] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[2896] *See* Winstar comments at 3.

interconnection or for access to unbundled elements under section 251(c)(6).[2897] The intent of Congress in section 224(f) was to permit cable operators and telecommunications carriers to "piggyback" along distribution networks owned or controlled by utilities, as opposed to granting access to every piece of equipment or real property owned or controlled by the utility.[2898]

1186. The statute does not describe the specific type of telecommunications or cable equipment that may be attached when access to utility facilities is mandated.[2899] We do not believe that establishing an exhaustive list of such equipment is advisable or even possible. We presume that the size, weight, and other characteristics of attaching equipment have an impact on the utility's assessment of the factors determined by the statute to be pertinent -- capacity, safety, reliability, and engineering principles. The question of access should be decided based on those factors.

3. Constitutional Takings

a. Background

1187. The access provisions of section 224(f) restrict the right of a utility to exclude third parties from its property and therefore may raise Fifth Amendment issues.[2900] While we have no jurisdiction to determine the constitutionality of a federal statute, constitutional concerns are relevant for purposes of construing a statute.[2901] For that reason, we here consider the constitutional issues raised in the comments.

b. Comments

1188. A number of utilities suggest that we must construe section 224(f) as permitting them to make the ultimate decision as to whether to grant access to their facilities and rights-of-way, on the grounds that a statute compelling them to grant access would be an unconstitutional

[2897] *See supra*, Section VI.B.

[2898] Ohio Edison reply at 12.

[2899] "The term 'pole attachment' means any attachment by a cable television system or provider of telecommunications service to a pole, duct, conduit, or right-of-way owned or controlled by a utility." 47 U.S.C. § 224(a)(4).

[2900] *See Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

[2901] *Bell Atlantic Telephone Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

taking of their private property under the Fifth Amendment.[2902] AEP notes that in *FCC v. Florida Power Corp.* the Supreme Court upheld the 1978 Pole Attachments Act, in part because nothing in that statute compelled utilities "to enter into, renew, or refrain from terminating pole attachment agreements."[2903] By contrast, the Supreme Court held that a state law requiring a landlord to permit a cable operator to install and maintain cable facilities over the landlord's apartment building constituted a taking of private property.[2904] On the basis of these cases, AEP contends: "To pass constitutional muster, the access required under section 224(f)(1) must be voluntary."[2905] Likewise, Puget argues: "If the Commission interprets the act's access requirement broadly as mandating access to the facility owner's property to all who desire it, the Takings Clause would be violated."[2906]

1189. Other utilities argue that the Fifth Amendment is implicated by the access requirements of section 224(f)(1), but stop short of contending that mandating access under the statue renders it unconstitutional. U S West believes that any discussion of access under section 224(f)(1) "would be incomplete without explicit recognition of the fact that such mandatory occupation . . . constitutes the taking of private property. As such, both the Commission and respective state regulatory agencies must ensure that LECs receive just compensation for their taken property."[2907] Virginia Power believes that any mandatory access requirement would result in a taking of private property, and notes "the potential constitutional issue . . . ."[2908] UTC states that forced access "raises serious questions, regarding at least, the taking of property without just compensation."[2909] Finally, GTE suggests that mandatory access under section 224(f)(1) may be unconstitutional as a taking of private property without just compensation, when considered in conjunction with the method by which pole attachment rates will be determined under section 224(e)(2).[2910]

[2902] AEP comments at 7-10; Virginia Electric comments at 4; GTE comments at 23; Puget comments at 3; UTC comments at 4.

[2903] 480 U.S. 245, 251 n. 6 (1987).

[2904] *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

[2905] AEP comments at 7.

[2906] Puget comments at 3.

[2907] U S West comments at 16.

[2908] Virginia Power comments at 4.

[2909] UTC comments at 5.

[2910] GTE comments at 23 & n. 24.

1190. Other commenters contend that there are no relevant constitutional issues to be confronted. Cole argues that requiring a utility to connect its facilities with those of other parties is simply a condition of providing utility service.[2911] With respect to LECs, for instance, Cole states: "Part of the obligation of being a regulated telecommunications common carrier is to provide services deemed to be necessary by regulators whether the regulated common carrier 'wants' to provide them or not."[2912] Cole contends that mandatory access to poles and other facilities "has no impact on the applicable constitutional standard."[2913] "As long as the rates for pole space and services are not confiscatory," Cole asserts,"there simply is no taking."[2914] In the alternative, Cole argues that "even if the access provision of section 224(f)(1) does constitute a taking, any argument that the compensation provided by the statute is not compensatory must be decided in a specific case, and not in this generic rulemaking."[2915]

c. Discussion

1191. Section 224(f)(1) mandates that a utility grant access to a requesting telecommunications provider or cable system operator, subject to certain conditions that we discuss elsewhere in this Order. That provision is not reasonably susceptible of a reading that gives the pole owner the choice of whether to grant telecommunications carriers or cable television systems access. Even if such mandatory access results in a taking, we cannot agree that it necessarily raises a constitutional issue. The Fifth Amendment permits takings as long the property owner receives just compensation for the property taken.[2916]

1192. As for the amount of compensation provided under the statute, GTE suggests that mandatory access will result in an unconstitutional taking when considered in conjunction with the methodology for pole attachment rates set forth in section 224(e)(2). We, of course, have no power to declare any provision of the Communications Act unconstitutional.[2917] In any event, we cannot agree. Congress has provided for compensation to pole owners, in the event that they cannot resolve a dispute with telecommunications carriers regarding the charges for use of the

[2911] Cole comments at 28.

[2912] *Id.* at 7.

[2913] *Id.* at 29.

[2914] *Id.* at 31 [*citing FPC v. Hope Natural Gas*, 320 U.S. 591, 602 (1944)].

[2915] *Id.* at 31 [*citing WBEN v. United States*, 396 F.2d 601, 618 (2d Cir.), *cert. denied*, 393 U.S. 914 (1968)].

[2916] *Id.*

[2917] *See GTE California v. FCC*, 39 F.3d 940, 946 (9th Cir. 1994) (*citing Johnson v. Robison*, 415 U.S. 361, 368 (1974)).

owners' poles, that would allow them to recover the cost of providing usable space to each entity and two-thirds of the cost of the unusable space apportioned among such users. The Commission soon will initiate a separate rulemaking proceeding that will give greater content to this statutory standard. GTE and others may present their just compensation arguments with respect to the ratemaking standards the Commission adopts in that proceeding. GTE has not shown here, however, how the statutory standard contained in section 224(e) necessarily would deny pole owners just compensation.

4. Modifications

a. Background

1193. In the NPRM we sought comment on section 224(h) which provides:

> Whenever the owner of a pole, duct, conduit, or right-of-way intends to modify or alter such pole, duct, conduit, or right-of-way, the owner shall provide written notification of such action to any entity that has obtained an attachment to such conduit or right-of-way so that such entity may have a reasonable opportunity to add to or modify its existing attachment. Any entity that adds to or modifies its existing attachment after receiving such notification shall bear a proportionate share of the costs incurred by the owner in making such pole, duct, conduit, or right-of-way accessible.[2918]

1194. The NPRM requested comments addressing the manner and timing of the notice that must be provided to ensure a reasonable opportunity to add to or modify its attachment. In addition, we sought comment regarding the establishment of rules apportioning the cost of a modification among the various users of the modified facility. Finally, we requested comment on whether any payment of costs should be offset by the potential increase in revenues to the owner. If, for example, an owner modifies a pole to allow additional attachments that generate additional fees for the owner, should such revenues offset the share of modification costs borne by entities with preexisting access to the pole?

b. Comments

(1) Manner and Timing of Notice

1195. Several commenters state that no firm notice period should be established, due to the impracticalities of applying a single standard to the wide variety of situations that may necessitate modifications. Ameritech argues that the appropriate manner and timing for notice will vary according to local factors, such as the specific facility, the attachment, and the nature,

[2918] 47 U.S.C. § 224(h).

extent and reason for the change.[2919] According to Ameritech, time frames for responding to circumstances will vary according to the reason for the modification, including modifications due to damage, deterioration, technological improvements, public works projects and demand growth. Given these variables, Ameritech contends that rigid notification rules could impair the facility owner's ability to respond to emergencies, and would unnecessarily complicate and delay expansion, improvement and maintenance of facilities.[2920]

1196. Most of the commenters agree that exceptions to any firm notice requirements should be made for emergency situations, such as storm restoration work, and minor modifications.[2921] Electric utilities argue that written notification requirements must not restrict their ability to respond to emergencies, customer complaints or routine maintenance.[2922] Incumbent LECs echo these suggestions.[2923] Duquesne urges an exception to any specific notice requirement where the utility's database does not show that the attachment exists.[2924] Duquesne contends that telecommunications providers often make attachments without prior notice to the utility. Although the utility will discover the attachment when it goes to service the pole, Duquesne argues it should not have to suspend that service to give notice to a communications provider that attached without notice to the utility. As proposed by Duquesne, this exception would sunset in five years, by which time the utility would be required to have an accurate database.[2925]

1197. Those commenters who propose specific notice periods varied widely with regard to what they deem "reasonable" notice: periods of 10,[2926] 30,[2927] 60,[2928] 90,[2929] and 180[2930] days

[2919] Ameritech comments at 39.

[2920] *Id.; accord,* ConEd comments at 13; NU System Companies comments at 6.

[2921] Ameritech comments at 39; AT&T reply at 20; Bell Atlantic comments at 15; ConEd comments at 13-14; Delmarva comments at 23-24; Duquesne comments at 24-25; MFS comments at 12; NU System Companies comments at 6.

[2922] Public Service Company of New Mexico comments at 27; Virginia Electric comments at 19; Carolina Power reply at 2; American Electric Power reply at 41-43.

[2923] USTA comments at 10; Bell Atlantic comments at 15; SBC reply at 31-32.

[2924] Duquesne comments at 25.

[2925] *Id.*

[2926] AT&T comments at 20; Delmarva comments at 23-24; Duquesne comments at 24.

[2927] PECO comments at 8. PECO also notes that a period exceeding 30 days may be appropriate in the case of particular rights-of-ways, such as ducts, which have special logistical difficulties and greater expenses associated with them. *Id.* at 9.

were recommended, with at least one commenter requesting a full year's notice before modifications could take place.[2931] In justifying the various notice periods and exceptions presented, commenters cite existing notification periods in standard contracts.[2932] They also express concerns that longer periods would interfere with a utility's ability to allocate work crews and schedule necessary outages efficiently,[2933] that upgrade schedules could be disrupted if a longer period were mandated,[2934] or that longer periods would be necessary to allow users to determine future business and economic needs.[2935] Teleport recommends that modifications which benefit only some users should not interrupt usage by others.[2936]

1198. A number of commenters express a preference for negotiated notification terms.[2937] For example, BellSouth currently negotiates contractual notice provisions with attaching communications providers and expresses concern that these contracts may have to be re-negotiated should rigid notice periods be established.[2938] BellSouth also has online notification programs, which it argues should be recognized as meeting any written notification obligations.[2939] Similarly, NEES points out that a group of New England utilities, local exchange carriers, and cable systems are developing a joint electronic information system for all construction-related notifications, and notes that specific notice requirements could reduce the effectiveness of such a system.[2940] Bell Atlantic argues that any duty of notice should be deemed waived when an

[2928] AT&T comments at 20, and AT&T reply at 20; GST Telecom comments at 7; U S West comments at 19.

[2929] Cole comments at 20; MFS comments at 11; Time Warner comments at 15.

[2930] MCI comments at 25.

[2931] Teleport comments at 10.

[2932] Cole comments at 20.

[2933] PECO comments at 8; USTA comments at 10, reply at 9.

[2934] PECO comments at 8.

[2935] Teleport comments at 10.

[2936] *Id.*

[2937] *See, e.g.,* Bell Atlantic comments at 15; GTE comments at 27; Illinois Commission Comments at 72-73; NEES comments at 15-16; PacTel comments at 18; USTA reply at 9.

[2938] BellSouth comments at 17-18.

[2939] *Id.,* at 18 n.39.

[2940] NEES comments at 16.

attachment contract grants the utility modification power as needed.[2941]

(2) Allocation of Costs

1199. Several commenters argue that the circumstances surrounding modifications will vary so greatly that uniform application of a single cost allocation formula is infeasible.[2942] Others propose a variety of cost allocation formulas, including dividing the total cost of the modification by the number of entities modifying their attachments,[2943] tying an entity's share of modification costs to the share of space reserved on the pole for that entity's use,[2944] and applying a total service long-run incremental cost methodology based on proportionate space used by each carrier.[2945] One commenter suggests that costs of modifications should be shared only when the user requests the modification, in which case the user would pay a *pro rata* share of the cost.[2946]

1200. AT&T contends that, while the attacher should pay the cost of the addition, if the addition involves more capacity than is needed by existing users, then the owner should pay the balance, subject to recovery later when other entities seek attachments.[2947] According to AT&T, attachers should not pay the cost of modifications by owner, but should only pay their share of the costs to make the structure accessible.[2948] AT&T adds that owners should not be allowed to charge new attachers for modifications paid for by existing attachers.[2949] PECO argues that if the utility has decided to replace a 50-foot pole with a 55-foot pole, an attaching party should not be permitted to request a 60-foot pole unless the requesting party intended to make a modification necessitating the 60-foot pole within six months. According to PECO, the requesting party should be permitted to reserve space in this manner only if it was willing to cover maintenance,

[2941] Bell Atlantic comments at 15.

[2942] Ameritech comments at 39-40; GTE comments at 28; USTA comments at 11; U S West comments at 20.

[2943] Bell Atlantic comments at 16; Delmarva comments at 24-25; Duquesne comments at 26. Duquesne also contends that section 224(e)(1) dictates that any such rule should apply to a party's "proportionate costs" only if the parties are unable to resolve a dispute over such charges. *Id.*

[2944] AT&T comments at 21, reply at 22; MCI comments at 25; USTA comments at 11.

[2945] MCI comments at 24.

[2946] Teleport comments at 11.

[2947] AT&T comments at 19.

[2948] *Id.*, at 21.

[2949] AT&T reply at 22.

insurance, and other operational costs associated with the reserved space.[2950]

1201. Cole observes that an applicant must pay for the make-ready needed to accommodate its own attachments. This would include the cost to pre-existing users to transfer their lines to new locations on the pole, or to install a new pole if such a pole is necessary to accommodate the new attachment.[2951] Cole argues that the new user should be protected from having to pay for preexisting NESC violations that are corrected at the same time the new attachment is made.[2952] In addition, reading sections 224(h) and (i) together,[2953] Cole concludes that, if a change out is required to correct a pre-existing utility violation on the pole, the utility must bear the cost of the change out, and should also be solely responsible for change out costs if the change out is attributable solely to the needs of the utility, such as an increase in the load carried by the utility. Under this approach, if a change out is necessitated by something other than the needs of an entity that already has, or seeks to have, an attachment, then entities with existing attachments must be given an opportunity to maintain or modify their attachments, with each party bearing their own costs. As an example, all attaching parties would share the cost of a new pole that was needed due to a road widening project.[2954]

1202. A few commenters suggest that cost arrangements currently in place in certain states should be considered as possible solutions to this problem. For example, ConEd recommends adoption of the rule which it says is currently applied in New York and is an accepted practice: "If a utility causes an attachment to be modified within two years of an attachment, then the utility is responsible for the modification. (However, if it is the attaching entity, then the provider would be responsible for these costs.) Then, if a modification is made after two years, the provider is required to pay the costs of the modification."[2955] PacTel currently bills the attacher when it modifies a conduit to facilitate space for that attacher; if the modification is to benefit PacTel, PacTel picks up the whole cost. PacTel requests that this approach, which is currently used in California and Nevada, be recognized as a safe harbor under the 1996 Act.[2956] The NU System Companies contend that costs should be borne equally by all parties that have existing attachments on the facility, claiming that this method has generally been

[2950] *Id.*

[2951] Cole comments at 18.

[2952] *Id.; accord,* Summit comments at 1.

[2953] Note that section 224 (i) was not the subject of the *Notice*.

[2954] Cole comments at 19.

[2955] ConEd comments at 14.

[2956] PacTel comments at 22.

used among electric and telephone companies in its territories.[2957]

1203. Measuring modification costs poses a separate concern. Electric utilities, for example, contend that modification costs incurred to accommodate an attaching entity impose long-term costs beyond the initial cost of modification. Utilities have argued that the presence of attachments adds to the cost of maintaining and modifying the facility. One commenter suggests that modifications to increase pole height to accommodate attaching parties could impose on utilities additional costs of new trucks to service the pole.[2958] According to this commenter, unless attaching parties cover these added costs, utility owners will be subsidizing attaching parties on a continuous basis.[2959] At the same time, some commenters suggest that facility owners may engage in unnecessary or unduly burdensome modifications, imposing costs that could discourage new entrants from offering telecommunications services.[2960] Other commenters contend that normal market forces will prevent facility owners from making such modifications.[2961]

1204. Delmarva contends that it will be difficult, if not impossible, for the Commission to establish a rule that fairly defines what modifications are "unnecessary or unduly burdensome." Similarly, the NU System Companies argue that limitations on an owner's right to modify a facility and on "unnecessary or unduly burdensome modifications" would potentially and directly interfere with crucial day-to-day utility operations. They further argues that applicable codes, state laws and company standards will generally dictate when and where modifications are needed, and it would be impractical to suggest a "limitation" or standard that could be applied in all cases.[2962] A number of commenters note that if a utility seeks to modify a facility and the attaching carrier will not benefit from the modification, the attaching entity bears none of the costs associated with the modification. Given the large costs associated with such arrangements, this allocation of rearrangement costs will preclude utilities from making any "unnecessary or unduly burdensome" modifications, according to these commenters.[2963]

[2957] NU System Companies comments at 6-7.

[2958] UTC comments at 18.

[2959] *Id.*; *see* Puget Sound comments at 5-6.

[2960] WinStar comments at 8; Teleport comments at 10; GST Telecom comments at 8; NCTA reply at 7-8.

[2961] *See, e.g.*, Bell Atlantic comments at 15, Public Service Company of New Mexico reply at 18-19.

[2962] NU System Companies comments at 7.

[2963] Delmarva comments at 26-27; *accord* Duquesne comments at 28.

1205. Some commenters supported,[2964] while many opposed,[2965] our proposal to require facility owners to offset modification costs with additional revenues from new attachments made possible by those modifications. Several of those opposed to offsetting note that pole owners modify out of necessity, not to attract additional attachers, and any additional revenues generated by the new capacity added through modifications would be speculative.[2966] One commenter notes that offsetting costs by potential additional revenues would be inconsistent with a scheme that allocates the cost of modifications only to those parties who benefit from such modifications.[2967] ConEd adds that the facility belongs to the utility and it therefore should be permitted to receive any revenues it can from the use of those facilities.[2968]

1206. Cole suggests that regular attachment fees paid over the term of a pole attachment agreement constitute a return on the utility's investment in the pole. Cole contends such fees should be minimal if parties with attachments have contributed to the cost of a new pole. "Otherwise," Cole states, "the utility will be recovering a return and other compensation for an investment which was made in part by its tenants."[2969] In such circumstances, Cole recommends that the ongoing rental fee should be limited to the incremental cost to the utility of the attachment.[2970]

c. Discussion

1207. We recognize that, when a modification is planned, parties with preexisting attachments to a pole or conduit need time to evaluate how the proposed modification affects their interest and whether activity related to the modification presents an opportunity to adjust the attachment in a desirable manner.[2971] At the same time, we also recognize that not all adjustments to utility facilities are alike. Some adjustments may be sufficiently routine or minor as to not create the type of opportunity that triggers the notice requirement.[2972] Indeed, it is possible that in

[2964] AT&T comments at 21; GST Telecom comments at 9.

[2965] ConEd comments at 14; Delmarva comments at 25-26; Duquesne comments at 27; NEES comments at 16.

[2966] Bell Atlantic comments at 16; NU Systems comments at 7; NEES comments at 16; PECO comments at 10.

[2967] Duquesne comments at 27.

[2968] ConEd comments at 14.

[2969] Cole comments at 20.

[2970] *Id.*

[2971] Teleport comments at 10; AT&T reply at 20.

[2972] USTA comments at 10; Bell Atlantic comments at 15; MFS comments at 12; SBC reply at 33.

some cases lengthy notice requirements could delay unnecessarily the kinds of modifications that would expedite the onset of meaningful competition in the provision of telecommunications services.[2973] Although the period of advance notice has varied widely among commenters, we note that 60 days has been advocated by several parties.[2974]

1208. Several commenters expressed a preference for negotiated notification terms.[2975] They have explained that circumstances will vary among owners of facilities.[2976] The time needed to commence a modification could vary according to pole conditions, technological improvements and demand growth.[2977] Attaching parties in rural markets may need more time to study facilities than facility users in urban markets.[2978] To demonstrate their ability to develop appropriate negotiated agreements, some commenters have described notice requirements in existing agreements. Such cases, they contend, illustrate that notification rules are unnecessary.[2979]

1209. We conclude that, absent a private agreement establishing notification procedures, written notification of a modification must be provided to parties holding attachments on the facility to be modified at least 60 days prior to the commencement of the physical modification itself. Notice should be sufficiently specific to apprise the recipient of the nature and scope of the planned modification. These notice requirements should provide small entities with sufficient time to evaluate the impact of or opportunities made possible by the proposed modifications on their interests and plan accordingly.[2980] If the contemplated modification involves an emergency situation for which advanced written notice would prove impractical, the notice requirement does not apply except that notice should be given as soon as reasonably practicable, which in some cases may be after the modification is completed. Further, we believe that the burden of requiring specific written notice of routine maintenance activities would not produce a commensurate benefit. Utilities and parties with attachments should exchange maintenance

[2973] AT&T reply at 20; USTA reply at 9; U S West reply at 8; Massachusetts Electric, *et al.*, reply at 4-5.

[2974] *See, e.g.*, U S West comments at 19; AT&T comments at 20; GST Telecom comments at 7; AT&T reply at 20; Cincinnati Bell reply at 6.

[2975] GTE comments at 28; PacTel comments at 21-22; Rural Tel. Coalition comments at 16; American Electric Power reply at 40; Ohio Edison reply at 23.

[2976] American Electric Power comments at 46.

[2977] Ameritech comments at 39; Municipal Utilities reply at 6-7; Cincinnati Bell reply at 6.

[2978] GVNW comments at 11.

[2979] PacTel comments at 21-22; BellSouth comments at 17-18; American Electric Power reply at 40.

[2980] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

handbooks or other written descriptions of their standard maintenance practices.[2981] Changes to these practices should be made only upon 60 days written notice. Recognizing that the parties themselves are best able to determine the circumstances where notice would be reasonable and sufficient, as well as the types of modifications that should trigger notice obligations, we encourage the owner of a facility and parties with attachments to negotiate acceptable notification terms.

1210. Even with the adoption of a specific notice period, however, we still encourage communication among owners and attaching parties. Indeed, in cases where owners and users routinely share information about upgrades and modifications, agreements regarding notice periods and procedures are ancillary matters.[2982]

1211. With respect to the allocation of modification costs, we conclude that, to the extent the cost of a modification is incurred for the specific benefit of any particular party, the benefiting party will be obligated to assume the cost of the modification, or to bear its proportionate share of cost with all other attaching entities participating in the modification.[2983] If a user's modification affects the attachments of others who do not initiate or request the modification, such as the movement of other attachments as part of a primary modification, the modification cost will be covered by the initiating or requesting party.[2984] Where multiple parties join in the modification, each party's proportionate share of the total cost shall be based on the ratio of the amount of new space occupied by that party to the total amount of new space occupied by all of the parties joining in the modification. For example, a CAP's access request might require the installation of a new pole that is five feet taller than the old pole, even though the CAP needs only two feet of space. At the same time, a cable operator may claim one foot of the newly-created capacity. If these were the only parties participating in the modification, the CAP would pay two-thirds of the modification costs and the cable operator one-third.

1212. As a general approach, requiring that modification costs be paid only by entities for whose benefit the modification is made simplifies the modification process. For these purposes, however, if an entity uses a proposed modification as an opportunity to adjust its preexisting attachment, the "piggybacking" entity should share in the overall cost of the modification to reflect its contribution to the resulting structural change. A utility or other party that uses a modification as an opportunity to bring its facilities into compliance with applicable safety or

[2981] Although we do not offer a definition of "routine maintenance" in this proceeding, we anticipate that the parties to an attachment agreement will have established understandings in this regard. We do not believe that routine maintenance of a facility encompasses actions that would disrupt or impair the service of a facility user.

[2982] Frontier comments at 7.

[2983] NYNEX reply at 8; Carolina Power Reply comments at 3.

[2984] Cole comments at 18; MFS reply at 24.

other requirements will be deemed to be sharing in the modification and will be responsible for its share of the modification cost. This will discourage parties from postponing necessary repairs in an effort to avoid the associated costs.

1213. We recognize that limiting cost burdens to entities that initiate a modification, or piggyback on another's modification, may confer incidental benefits on other parties with preexisting attachments on the newly modified facility. Nevertheless, if a modification would not have occurred absent the action of the initiating party, the cost should not be borne by those that did not take advantage of the opportunity by modifying their own facilities. Indeed, the Conference Report accompanying the passage of the 1996 Act imposes cost sharing obligations on an entity "that takes advantage of such opportunity to modify its own attachments." This suggests that an attaching party, incidentally benefiting from a modification, but not initiating or affirmatively participating in one, should not be responsible for the resulting cost.[2985] As for pole owners themselves, the imposition of cost burdens for modifications they do not initiate could be particularly cumbersome if excess space created by modifications remained unused for extended periods.[2986]

1214. Apart from entities that initiate modifications and preexisting attachers that use the opportunity to modify their own attachments, some entities may seek to add new attachments to the modified facility after the modification is completed to avoid any obligation to share in the cost. If this occurs, the entity initiating and paying for the modification might pay the entire cost of expanding a facility's capacity only to see a new competitor take advantage of the additional capacity without sharing in the cost.[2987] Moreover, entities with preexisting attachments may, due to cost considerations, forgo the opportunity to adjust their attachment only to see a new entrant attach to a pole without sharing the modification cost. To protect the initiators of modifications from absorbing costs that should be shared by others, we will allow the modifying party or parties to recover a proportionate share of the modification costs from parties that later are able to obtain access as a result of the modification. The proportionate share of the subsequent attacher should be reduced to take account of depreciation to the pole or other facility that has occurred since the modification. These provisions are intended to ensure that new entrants, especially small entities with limited resources, bear only their proportionate costs and are not forced to subsidize their later-entering competitors. To the extent small entities avail themselves of this cost-saving mechanism, however, they will incur certain record keeping obligations.[2988]

[2985] GST Telecom comments at 8; MFS comments at 12; NCTA reply at 8.

[2986] Cincinnati Bell reply at 8.

[2987] *See* AT&T comments at 19.

[2988] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

1215. Parties requesting or joining in a modification also will be responsible for resulting costs to maintain the facility on an ongoing basis. We believe determining the method by which to allocate such costs can best be resolved in the context of a proceeding addressing the determination of appropriate rates for pole attachments or other facility uses.[2989] We will postpone consideration of these issues until such time.

1216. We recognize that in some cases a facility modification will create excess capacity that eventually becomes a source of revenue for the facility owner, even though the owner did not share in the costs of the modification.[2990] We do not believe that this requires the owner to use those revenues to compensate the parties that did pay for the modification. Section 224(h) limits responsibility for modification costs to any party that "adds to or modifies its existing attachment after receiving notice" of a proposed modification.[2991] The statute does not give that party any interest in the pole or conduit other than access. Creating a right for that party to share in future revenues from the modification would be tantamount to bestowing an interest that the statute withholds.[2992] Requiring an owner to offset modification costs by the amount of future revenues emanating from the modification expands the category of responsible parties based on factors that Congress did not identify as relevant. Since Congress did not provide for an offset, we will not impose it ourselves. Indeed, a requirement that utilities pass additional attachment fees back to parties with preexisting attachments may be a disincentive to add new competitors to modified facilities, in direct contravention of the general intent of Congress.

5. Dispute Resolution

a. Background

1217. Implementation of the access requirements of sections 224 and 251(b)(4) require the adoption of enforcement procedures. In the NPRM, we sought comment on, among other things, whether to impose upon a utility the burden of justifying its denial of access to its poles, ducts, conduits, and rights-of-way due to lack of capacity, safety, reliability, and engineering issues.[2993]

b. Comments

[2989] BellSouth comments at 18; NYNEX comments at 14; SBC comments at 18.

[2990] AT&T comments at 21; GST Telecom comments at 9; WinStar reply at 8-9.

[2991] 47 U.S.C. § 224(h).

[2992] American Electric Power reply at 46.

[2993] NPRM at para. 223; *see* 47 U.S.C. § 224(f)(2).

1218. With respect to dispute resolution procedures generally, a few commenters note that existing complaint procedure mechanisms have worked well in the cable television pole context and should be adequate in this broader context as well.[2994] Other commenters argue that dispute resolution should be left to the states, with federal intervention only where the states failed to regulate.[2995] Some commenters request that any complaint mechanism established should provide for the expeditious resolution of disputes, with short time frames for responses and final resolution.[2996]

1219. Several commenters argue that, where access has been denied, the party denying access should have the burden of proving that such denial was justified.[2997] Others contend that, historically, cable operators have had the burden of proof in pole attachment cases, and that no principled basis exists for altering historic procedures.[2998] In addition, commenters expressed concern that placing the burden of proof on a utility unfairly presumes bad faith.[2999]

1220. PECO agrees with some cable commenters that the reasonableness of a denial of access should be based on industry safety and operational standards. A restriction on access imposed in accordance with such standards should be irrebuttably presumed reasonable, according to PECO. If the utility seeks to impose stricter standards, the burden would be on the utility to establish the reasonableness of the stricter standard. Predicting the likelihood of fact-intense disputes on such issues, PECO recommends the adoption of adequate dispute-resolution procedures.[3000] Similarly, Cole contends that a utility cannot deny a request for access based upon safety or reliability concerns as long as the applicant is willing to undertake the obligations necessary to comply with NESC standards.[3001] Safety and reliability standards that exceed NESC standards should be presumed unreasonable if they are used to deny access to a pole. The utility

[2994] *See, e.g.*, BellSouth reply at 16-17; GTE reply at 29-30; U S West reply at 8.

[2995] ICC comments at 72-73; Bell Atlantic reply at 10-11; GTE reply at 29-30; PacTel reply at 27.

[2996] *See, e.g.*, Joint Cable commenters at 20-22; NEXTLINK comments at 6-7.

[2997] Delmarva comments at 19; Duquesne comments at 22; Joint Cable commenters at 20-22; NEXTLINK comments at 6-7; OCC reply at 6; PUCO Staff comments at 11-12; Sprint reply at 20.

[2998] ConEd comments at 12; American Electric Power reply at 32-36; BellSouth reply at 16-17; SBC reply at 26-27.

[2999] GTE reply at 26-27; NEES comments at 14.

[3000] PECO comments at 6.

[3001] Cole comments at 16.

would then have the burden of showing the reasonableness of such standards.[3002]

1221. Duquesne argues that it is appropriate for the utility to bear the burden of establishing a threat to reliability if that rationale is used to deny access. Once a utility makes a showing, based on an engineering analysis, that the attachments "quantifiably threaten reliability," the burden would shift to the party seeking the attachment to show that the utility's analysis is incomplete or invalid, with the utility holding the ultimate burden of proof.[3003]

c. Discussion

(1) General Complaint Procedures Under Section 224

1222. Section 224(f)(2) provides that an electric utility may deny non-discriminatory access "where there is insufficient capacity and for reasons of safety, reliability and generally applicable engineering purposes."[3004] We have determined that other utilities also may consider these concerns when faced with an access request.[3005] A denial of access, while proper in some cases, is an exception to the general mandate of section 224(f). We note that utilities contend that they are in the best position to determine when access should be denied, because they possess the information and expertise to make such decisions and because of the varied circumstances impacting these decisions.[3006] We think it appropriate that the utility bear the burden of justifying why its denial of access to a cable television or telecommunications carrier fits within that exception.[3007] We therefore agree that utilities have the ultimate burden of proof in denial-of-access cases.[3008] We believe this will minimize uncertainty and reduce litigation and transaction costs, because new entrants generally, and small entities in particular, are unlikely to have access to the relevant information without cooperation from the utilities.[3009]

[3002] *Id.*, at 17-18.

[3003] Duquesne comments at 22; *accord* Delmarva Comments at 19.

[3004] *See* 47 U.S.C. § 224(f)(2).

[3005] *See supra*, Section B(1)(c)(2).

[3006] *See generally* Comments of American Electric Power; Delmarva Power and Light; NEES; Puget Sound; Public Service Company of New Mexico; UTC; Virginia Power.

[3007] Public Service Company of New Mexico at 20-23; Delmarva Power and Light at 19; Joint Cable commenters at 18; WinStar reply at 7; Sprint reply at 20.

[3008] Comments of Public Service Company of New Mexico at 20-23; Ohio Consumers' Counsel reply at 6; PUCO Staff comments at 12.

[3009] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

1223. We also agree with Virginia Power that a telecommunications carrier or cable television provider filing a complaint with the Commission must establish a prima facie case.[3010] A petitioner's complaint, in addition to showing that it is timely filed, must state the grounds given for the denial of access, the reasons those grounds are unjust or unreasonable, and the remedy sought. The complaint must be supported by the written request for access, the utility's response, and information supporting its position.[3011] The Commission will deny the petitioner's claim if a prima facie case is not established.[3012] A complaint will not be dismissed if a petitioner is unable to obtain a utility's written response, or if a petitioner is denied any other relevant information by the utility needed to establish a prima facie case. Thus, we expect a utility that receives a legitimate inquiry regarding access to its facilities or property to make its maps, plats, and other relevant data available for inspection and copying by the requesting party, subject to reasonable conditions to protect proprietary information.[3013] This provision eliminates the need for costly discovery in pursuing a claim of improper denial of access, allowing attaching parties, including small entities with limited resources, to seek redress of such denials.[3014]

1224. We agree with the Joint Cable Commenters that "time is of the essence."[3015] The Joint Cable Commenters contend that the Commission should implement an expedited review process for denial of access cases.[3016] By implementing specific complaint procedures for denial of access cases, we seek to establish swift and specific enforcement procedures that will allow for competition where access can be provided.[3017] In order to provide a complete record, written requests for access must be provided to the utility. If access is not granted within 45 days of the request, the utility must confirm the denial in writing by the 45th day. Although these written requirements involve some recordkeeping obligations, which could impose a burden on small incumbent LECs and small entities, we believe that burden is outweighed by the benefits of

[3010] Virginia Power comments at 14; American Electric Power comments at 40-42; Carolina Power and Light comments at 5 (*citing* 47 C.F.R. § 1.1409(b)); *see also* SBC comments at 15-17.

[3011] Virginia Power comments at 15 (*citing* 47 C.F.R. § 1.1404(f) and (g)).

[3012] 47 C.F.R. § 1.1409(d).

[3013] AT&T comments at 19; GST comments at 6.

[3014] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601, et seq.

[3015] Joint Cable Commenters reply at 24.

[3016] Joint Cable Commenters reply at 25.

[3017] Joint Cable Commenters reply at 24.

certainty and expedient resolution of disputes which this procedure encourages.[3018] The denial must be specific, and include all relevant evidence or information supporting its denial. It must enumerate how the evidence relates to one of the reasons that access can be denied under section 224(f)(2), *i.e.*, lack of capacity, safety, reliability or engineering standards.

1225. For example, a utility may attempt to deny access because of lack of capacity on a 40-foot pole. We would expect a utility to provide the information demonstrating why there is no capacity. In addition, the utility should show why it declined to replace the pole with a 45-foot pole. Upon the receipt of a denial notice from the utility, the requesting party shall have 60 days to file its complaint with the Commission. We anticipate that by following this procedure the Commission will, upon receipt of a complaint, have all relevant information upon which to make its decision. The petition must be served pursuant to section 1.1404(b) of the Commission's rules.[3019] Final decisions relating to access will be resolved by the Commission expeditiously.[3020] Because we are using the expedited process described herein, we do not believe stays or other equitable relief will be granted in the absence of a specific showing, beyond the prima facie case, that such relief is warranted.

(2) Procedures Under Section 251

1226. A telecommunications carrier seeking access to the facilities or property of a LEC may invoke section 251(b)(4) in lieu of, or in addition to, section 244(f)(1). Because section 251(b)(4) mandates access "on rates terms, and conditions that are consistent with section 224," we believe that the section 224 complaint procedures established above should be available regardless of whether a telecommunications provider invokes section 224(f)(1) or section 251(b)(4), or both.

1227. If a telecommunications carrier seeks access to the facilities or property of an incumbent LEC, however, it shall have the option of invoking the procedures established by section 252 in lieu of filing a complaint under section 224. Section 252 governs procedures for the negotiation, arbitration, and approval of certain agreements between incumbent LECs and telecommunications carriers.[3021] In pertinent part, section 252(a)(1) provides:

[3018] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

[3019] 47 C.F.R. § 1.1404(b).

[3020] We note, however, that if the Commission requests additional information from any party, such party will have 5 days to respond to the request. Failure to provide the requested information within the 5 days, will result in a review of the record provided thus far.

[3021] 47 U.S.C. § 252. The requirements of section 252, and the conditions set forth in this section 3(a) of this Order, do not apply if the party seeking access is not a telecommunications carrier, or if the party receiving the request for access is not an incumbent LEC.

> Upon receiving a request for interconnection, services, or network elements pursuant to section 251, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) or (c) of section 251.[3022]

1228. Where parties are unable to reach an agreement under this section, any party may petition the relevant state commission to arbitrate the open issues.[3023] In resolving the dispute, the state commission must ensure, among other things, that the ultimate resolution "meet[s] the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251 . . . . ."[3024] The Commission may assume the state's authority under section 252 if the state "fails to carry out its responsibility" under that section.[3025]

1229. Section 251(c)(1) creates an obligation on the part of an incumbent LEC "to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements . . . " to fulfill its section 251(b)(4) obligation.[3026] Therefore, a telecommunications carrier may seek access to the facilities or property of an incumbent LEC pursuant to section 251(b)(4) and trigger the negotiation and arbitration procedures of section 252. If a telecommunications carrier intends to invoke the section 252 procedures, it should affirmatively state such intent in its formal request for access to the incumbent LEC. We impose this requirement because the two procedures have separate deadlines by which the parties may or must take certain steps, and therefore the incumbent LEC receiving the request has a need to know which procedure has been invoked. Section 224 shall be the default procedure that will apply if the telecommunications carrier fails to make an affirmative election.

1230. We note that section 252 does not impose any obligations on utilities other than incumbent LECs, and does not grant rights to entities that are not telecommunications providers. Therefore, section 252 may be invoked in lieu of section 224 only by a telecommunications carrier and only if it is seeking access to the facilities or property of an incumbent LEC.

1231. In addition, incumbent LECs cannot use section 251(b)(4) as a means of gaining access to the facilities or property of a LEC. A LEC's obligation under section 251(b)(4) is to afford access "on rates, terms, and conditions that are consistent with section 224." Section 224

[3022] 47 U.S.C. § 251(a).

[3023] 47 U.S.C. § 252(b)(1).

[3024] 47 U.S.C. § 252(c)(1).

[3025] 47 U.S.C. § 252(e)(5).

[3026] 47 U.S.C. § 251(c)(1).

does not prescribe rates, terms, or conditions governing access by an incumbent LEC to the facilities or rights-of-way of a competing LEC. Indeed, section 224 does not provide access rights to incumbent LECs. We cannot infer that section 251(b)(4) restores to an incumbent LEC access rights expressly withheld by section 224. We give deference to the specific denial of access under section 224 over the more general access provisions of section 251(b)(4). Accordingly, no incumbent LEC may seek access to the facilities or rights-of-way of a LEC or any utility under either section 224 or section 251(b)(4).

6. Reverse preemption

a. Background

1232. Even prior to enactment of the 1996 Act, section 224(b)(1) gave the Commission jurisdiction to "regulate the rates, terms, and conditions for pole attachments . . . ."[3027] Under former section 224(c)(1), that jurisdiction was preempted where a state regulated such matters. Such reverse preemption was conditioned upon the state following a certification procedure and meeting certain compliance requirements set forth in sections 224(c)(2) and (3). The 1996 Act expanded the Commission's jurisdiction to include not just rates, terms, and conditions, but also the authority to regulate non-discriminatory access to poles, ducts, conduits and rights-of-way under section 224(f).[3028] At the same time, the 1996 Act expanded the preemptive authority of states to match the expanded scope of the Commission's jurisdiction. section 224(c)(1) now provides:

> Nothing in this section shall be construed to apply to, or to give the Commission jurisdiction with respect to rates, terms and conditions, or access to poles, ducts, conduits, and rights-of-way as provided in subsection (f), for pole attachments in any case where such matters are regulated by the State.[3029]

b. Comments

1233. Cole contends that the nondiscriminatory access provisions of section 224 and our jurisdiction thereunder survive when a telecommunications provider seeks access to the facilities or property of a LEC under section 251(b)(4), even where such matters are regulated by a

[3027] 47 U.S.C. § 224(b)(1).

[3028] 47 U.S.C. § 224(f).

[3029] 47 U.S.C. § 224(c)(1).

state.[3030] Cole notes that section 251(b)(4) requires LECs to afford access to its facilities and rights-of-way to competing telecommunications carriers "on rates, terms, and conditions that are consistent with section 224," with no reference to the possibility of state regulation.[3031] Cole further cites the competitive checklist of section 271 which requires an RBOC to provide such access "in accordance with the requirements of section 224," but which does not provide for state regulation of access.[3032] Cole argues that neither section 251 nor section 271 exempts a LEC or BOC from the access requirements of section 224 where the state has undertaken regulation of such matters. Cole argues that allowing states to preempt federal authority "would defeat the purpose of the Act to promote access" to local facilities.[3033]

1234. Similarly, Nextlink contends that the Commission's access requirements should apply to any LEC that receives an access request under section 251(b)(4), regardless of whether a state has attempted to assert jurisdiction under section 224(c).[3034] Nextlink describes section 251 as "an entirely separate section providing entirely different bases for Commission jurisdiction."[3035]

1235. Other commenters argue that a request for access under section 251(b)(4) always implicates section 224, including the provisions of section 224(c)(1) that allow the states to preempt federal regulation.[3036] The District of Columbia Commission argues that section 251(b)(4) only requires that access be given "'on rates, terms and conditions that are consistent with section 224.'"[3037] Thus, this commenter asserts that any federal regulation of access under section 251(b)(4) is subject to the state's authority under section 224(c)(1).[3038] Bell Atlantic agrees, arguing that the only obligation of section 251(b)(4) is to provide access consistent with section 224 and that providing access in accordance with a valid scheme of state access regulations meets this requirement, regardless of any federal access requirements that otherwise

[3030] Cole reply at 26-27.

[3031] 47 U.S.C. § 251(b)(4); *see* Cole comments at 26-27.

[3032] 47 U.S.C. § 271(c)(2)(b)(iii); *see* Cole comments at 27.

[3033] Cole reply at 27.

[3034] Nextlink reply at 5.

[3035] *Id.*

[3036] Ameritech comments at 33; NYNEX comments at 11-12; USTA reply at 7.

[3037] District of Columbia Commission comments at 9, *quoting* 47 U.S.C. § 251(b)(4).

[3038] *Id.*

would apply.[3039] UTC states that "the statute clearly gives the states authority to establish access requirements if they elect to assert jurisdiction."[3040]

c. Discussion

1236. To resolve this issue, we will begin with access requests that can arise solely under section 224(f)(1). These circumstances include when a cable system or telecommunications carrier seeks access to the facilities or rights-of-way of a non-LEC utility. In such cases, the expansion of the Commission's authority to require utilities to provide nondiscriminatory access under section 224(f) is countered by a corresponding expansion in the scope of a state's authority under section 224(c)(1) to preempt federal requirements. The authority of a state under section 224(c)(1) to preempt federal regulation in these cases is clear.[3041]

1237. The issue becomes more complicated when a telecommunications carrier seeks access to LEC facilities or property under section 251(b)(4). By its express terms, section 251(b)(4) imposes upon LECs, "[t]he duty to afford access to the poles, ducts, conduits, and rights-of-way of such a carrier to competing providers of telecommunications services on rates, terms and conditions that are consistent with section 224."[3042] We believe the reference in section 251(b)(4) to section 224 incorporates all aspects of the latter section, including the state preemption authority of section 224(c)(1). This interpretation is consistent not only with the plain meaning of the statute but with the overall application of sections 251 and 252.

1238. In the 1996 Act, Congress expanded section 224(c)(1) to reach access issues. Congress' clear grant of authority to the states to preempt federal regulation in these cases undercuts the suggestion that Congress sought to establish federal access regulations of universal applicability. Moreover, we do not find it significant that the access provisions of sections 251 and 271 contain no specific reference to the preemptive authority of states under section 224(c)(1), since both provisions expressly refer to section 224 generally.

1239. Thus, when a state has exercised its preemptive authority under section 224(c)(1), a LEC satisfies its duty under section 251(b)(4) to afford access by complying with the state's regulations. If a state has not exercised such preemptive authority, the LEC must comply with the

[3039] Bell Atlantic comments at 12.

[3040] UTC reply at 29.

[3041] As in other circumstances, and subject to certain limitations, the Commission may preempt an otherwise valid state or local access requirement that "prohibit[s] or ha[s] the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunication service." 47 U.S.C. § 253(a).

[3042] 47 U.S.C. § 254(b)(1)(4).

federal rules. Similarly, when a telecommunications carrier seeks access rights from an incumbent LEC by choosing to avail itself of the negotiation and arbitration procedures established in section 252, a state that has exercised its preemption rights will apply its own set of regulations in the arbitration process pursuant to section 252 (c)(1). Finally, we note that state regulation in this area is subject to the provisions of section 253.

1240. We note that Congress did not amend sections 224(c)(2) to prescribe a certification procedure with respect to access (as distinct from the rates, terms, and conditions of access). Therefore, upon the filing of an access complaint with the Commission, the defending party or the state itself should come forward to apprise us whether the state is regulating such matters.[3043] If so, we shall dismiss the complaint without prejudice to it being brought in the appropriate state forum. A party seeking to show that a state regulates access issues should cite to state laws and regulations governing access and establishing a procedure for resolving access complaints in a state forum. Especially probative will be a requirement that the relevant state authority resolve an access complaint within a set period of time following the filing of the complaint.[3044]

C. IMPOSING ADDITIONAL OBLIGATIONS ON LECS

1. Background

1241. Section 251(c) imposes obligations on incumbent LECs in addition to the obligations set forth in sections 251(a) and (b). It establishes obligations of incumbent LECs regarding: (1) good faith negotiation; (2) interconnection; (3) unbundling network elements; (4) resale; (5) providing notice of network changes; and (6) collocation.

1242. Section 251(h)(1) defines an incumbent LEC as a LEC within a particular service area that: (1) as of the enactment of the 1996 Act, provided telephone exchange service in such area; and (2) as of the enactment of the 1996 Act, was deemed to be a member of the exchange carrier association pursuant to 47 C.F.R. § 69.601(b) or, on or after the enactment of the 1996 Act, became a successor or assign of such carrier. Section 252(h)(2) provides that, "[t]he Commission may, by rule, provide for the treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if (A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1); (B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and (C) such treatment is consistent with the public interest, convenience, and necessity and the purposes

[3043] Our rules require service of a pole attachment complaint on both the defending utility and the state. 47 C.F.R. § 1.1404(b).

[3044] *See* 47 U.S.C. § 224(c)(3) (establishing deadlines for states to take final action on complaints concerning the rates, terms, or conditions of access).

of this section."[3045]

1243. In the NPRM, we sought comment on whether we should establish at this time standards and procedures by which interested parties could prove that a particular LEC should be treated as an incumbent LEC. We also sought comment on whether carriers that are not deemed to be incumbent LECs under section 251(h) may be required to comply with any or all of the obligations that apply to incumbent LECs, and whether states may impose on non-incumbent LECs the obligations that are imposed on incumbent LECs under section 251(c).[3046]

2. Comments

1244. Most parties that commented on the issue contend that the Commission should not establish in this proceeding standards and procedures for determining whether a LEC should be treated as an incumbent LEC.[3047]

1245. Many incumbent LECs and state commissions contend that it is not inconsistent with the Act for states to impose the requirements in section 251(c) on carriers that do not fall within the 1996 Act's definition of incumbent. These parties note that sections 251(d)(3), 252(e)(3), and 253(b) permit states to impose additional requirements on carriers.[3048] State commissions allege that they are in the best position to determine when it is appropriate to impose particular obligations on new entrants.[3049] These parties contend that state imposition of reciprocal obligations would be equitable,[3050] and would help promote fair negotiation and realistic demands by the new entrants.[3051]

[3045] 47 U.S.C. § 252(h)(2).

[3046] NPRM at paras. 44-45.

[3047] BellSouth comments at 10; NCTA comments at 15 n.46; Sprint comments at 10; Time Warner comments at 14; *contra* PacTel comments at 16.

[3048] *See, e.g.*, BellSouth comments at 10; California Commission comments at 12; Illinois Commission comments at 19-20 (it is not inconsistent with the Act for states to impose additional obligations on non-incumbents, although it would not be permissible for FCC to do so); Ohio Commission comments at 21-22; PacTel comments at 16; Pennsylvania Commission comments at 19.

[3049] *See, e.g.*, District of Columbia Commission comments at 14.

[3050] *See, e.g.*, Colorado Commission comments at 14-15; MECA comments at 18; Municipal Utilities comments at 10-12 (reciprocal obligations should be permitted as long as they are allowed under state law and city charter); Ohio Consumers' Counsel comments at 5-6 (the loop is a bottleneck regardless of whether the provider is an incumbent or a new entrant); Ohio Commission reply at 8.

[3051] *See, e.g.*, MCI comments at 16, 20; New Jersey Commission at 1.

1246. Potential local competitors argue that states may not impose any of the requirements of section 251(c) on non-incumbent LECs.[3052] These parties contend that the 1996 Act specifically imposes different, and additional obligations on incumbent carriers.[3053] In addition, these parties contend that imposing the same regulatory obligations on non-incumbents is unnecessary because they lack market power,[3054] and is contrary to Congress's desire to facilitate new entry into the local telephone market.[3055] In addition, they assert that section 251(h)(2), which gives the FCC authority to determine when to treat additional carriers as incumbent LECs, would be meaningless if states could decide on their own to subject any LEC to obligations imposed by section 251(c) on incumbent LECs.[3056] Some parties assert that states already impose reciprocal obligations on new entrants, or require them to comply with requirements the 1996 Act only imposes on incumbent LECs.[3057]

3. Discussion

1247. We conclude that allowing states to impose on non-incumbent LECs obligations that the 1996 Act designates as "Additional Obligations on Incumbent Local Exchange Carriers," distinct from obligations on all LECs,[3058] would be inconsistent with the statute.[3059] Some parties

[3052] *See, e.g.*, MCI comments at 5 n.7; MFS comments at 10; TCI comments at 14.

[3053] *See, e.g.*, ACTA comments at 5; Comcast comments at 17; Sprint comments at 10; Cox reply at 41; ICTA reply at 5.

[3054] *See, e.g.*, Comcast comments at 15-16; DoJ comments at 7 (absent a showing of market power, there is no basis for imposing additional obligations on new entrants); MCI comments at 5 n.7; Cox reply at 40; Time Warner reply at 11.

[3055] *See, e.g.*, Continental comments at 18; Metricom comments at 2 (imposing such requirements on non-dominant carriers would hinder competition); NEXTLINK comments at 15-16 (for states to impose additional obligations on non-incumbent LECs could constitute a barrier to entry in violation of section 253); Cox reply at 41; ICTA reply at 6 (imposing 251(c) requirements on new entrants would raise costs and thereby discourage potential competitors from entering the local market).

[3056] *See, e.g.*, GST comments at 3-4; MFS comments at 10; Time Warner comments at 15 (fact that Congress authorizes the FCC (but not state commissions) to impose incumbent obligations on the FCC suggests that Congress did not intend to give states that authority); TCI reply at 12; Teleport reply at 36.

[3057] TCI comments at 14 n.23; *see also* Colorado Commission comments at 11-12 (stating that it exempts new entrants from certain rules for a period of three years, after which the new entrant must demonstrate the continued need for such exemption); Illinois Commission comments at 19 (stating that it imposes intraLATA presubscription and line-side interconnection obligations on new entrants for policy reasons).

[3058] *Compare* 47 U.S.C. §§ 251(b) and 251(c).

assert that certain provisions of the 1996 Act, such as sections 252(e)(3) and 253(b), explicitly permit states to impose additional obligations. Such additional obligations, however, must be consistent with the language and purposes of the 1996 Act.

1248. Section 251(h)(2) sets forth a process by which the FCC may decide to treat LECs as incumbent LECs. Thus, when the conditions set forth in section 251(h)(2) are met, the 1996 Act contemplates that new entrants will be subject to the same obligations imposed on incumbents. While we find that states may not unilaterally impose on non-incumbent LECs obligations the 1996 Act expressly imposes only on incumbent LECs, we find that state commissions or other interested parties could ask the FCC to classify a carrier as an incumbent LEC pursuant to section 251(h)(2). At this time, we decline to adopt specific procedures or standards for determining whether a LEC should be treated as an incumbent LEC. Instead, we will permit interested parties to ask the FCC to issue an order declaring a particular LEC or a class or category of LECs to be treated as incumbent LECs. We expect to give particular consideration to filings from state commissions. We further anticipate that we will not impose incumbent LEC obligations on non-incumbent LECs absent a clear and convincing showing that the LEC occupies a position in the telephone exchange market comparable to the position held by an incumbent LEC, has substantially replaced an incumbent LEC, and that such treatment would serve the public interest, convenience, and necessity and the purposes of section 251.[3060]

[3059] We understand that some states may be imposing on non-incumbent LECs obligations set forth in section 251(c). *See, e.g.*, Colorado Commission comments at 11-12; Draft Decision, State of Connecticut Department of Public Utility Control, Docket No. 94-10-04 at 60, 65 (Connecticut Commission July 11, 1996); Illinois Commission comments at 19. We believe that these actions may be inconsistent with the 1996 Act.

[3060] 47 U.S.C. § 251(h)(2).

XII. EXEMPTIONS, SUSPENSIONS, AND MODIFICATIONS OF SECTION 251 REQUIREMENTS

A. BACKGROUND

1249. Section 251(f)(1) grants rural telephone companies an exemption from section 251(c), until the rural telephone company has received a bona fide request for interconnection, services, or network elements, and the state commission determines that the exemption should be terminated.[3061] Section 251(f)(2) allows LECs with fewer than two percent of the nation's subscriber lines to petition a state commission for a suspension or modification of any requirements of sections 251(b) and (c). Section 251(f) imposes a duty on state commissions to make determinations under this section, and establishes the criteria and procedures for the state commissions to follow. In the NPRM, we tentatively concluded that state commissions have the sole authority to make determinations under section 251(f). In addition, we sought comment on whether we should issue guidelines to assist state commissions when they make determinations regarding exemptions, suspensions, or modifications under section 251(f).

1250. Although subsections (f)(1) and (f)(2) both address the circumstances under which an incumbent LEC could be relieved of duties otherwise imposed by section 251, subsection 251(f)(2) also applies to non-incumbent LECs. The standard for determining whether to exempt a carrier under subsection 251(f)(1) is different from the standard for determining whether to grant a suspension or modification under subsection (f)(2). Subsection 251(f)(1)(B) requires state commissions to determine that terminating a rural exemption is consistent with the universal service provisions of the 1996 Act.[3062] Subsection 251(f)(2)(A)(i) requires state commissions to grant a suspension or modification if it is necessary to "avoid a significant adverse economic impact on users of telecommunications services generally," and subsection 251(f)(2)(B) requires a suspension or modification to be "consistent with the public interest, convenience, and necessity."[3063] Although we address these two subsections together, we highlight instances in which we believe that differences in statutory language require different treatment by state

[3061] A rural telephone company is defined as a local exchange carrier operating entity to the extent that such entity "(A) provides common carrier service to any local exchange carrier study area that does not include either– (i) any incorporated place of 10,000 inhabitants or more, or any part thereof . . .; or (ii) any territory, incorporated or unincorporated, included in an urbanized area . . .; (B) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines; (C) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (D) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment of the Telecommunications Act of 1996." 47 U.S.C. § 153(37).

[3062] The provision states, "the State commission shall terminate the exemption if the request . . . is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof)." 47 U.S.C. § 251(f)(1)(B).

[3063] 47 U.S.C. § 251(f)(2).

commissions.

1251. We discuss below issues raised by the commenters, and establish some rules regarding the requirements of section 251(f) that we believe will assist state commissions as they carry out their duties under section 251(f). For the most part, however, we expect that states will interpret the requirements of section 251(f) through rulemaking and adjudicative proceedings. We may in the future initiate a Notice of Proposed Rulemaking on certain additional issues raised by section 251(f) if it appears that further action by the Commission is warranted.

B. NEED FOR NATIONAL RULES

1. Comments

1252. Most state commissions[3064] and some other parties[3065] assert that states should have exclusive responsibility for the guidelines and determinations made under this section. Several commenters contend that any guidelines the Commission might issue would be useless, because generalized national guidelines could not take into account the variations among states and among individual LECs.[3066] For example, the Minnesota Independent Coalition argues that the additional grant of authority to states under section 214(e) confirms that state commissions have the sole authority to make determinations under section 251(f).[3067] A number of small telephone companies and associations of LECs advocate mandatory national rules regarding implementation of section 251(f). They assert that such rules would ensure that states carry out this provision in accordance with congressional intent.[3068] Some commenters favor a middle ground, claiming that non-mandatory guidelines from the Commission would be helpful, but that mandatory requirements would conflict with the Act's delegation to the states to make determinations under

[3064] *See, e.g.*, Alaska Commission comments at 6; Alabama Commission comments at 33-34; California Commission comments at 46; Idaho Commission comments at 14; Illinois Commission comments at 84; Louisiana Commission comments at 22-23; Ohio Commission comments at 80; Oregon Commission comments at 31; Pennsylvania Commission comments at 42; Texas Commission comments at 34; Wyoming Commission comments at 38-39.

[3065] Ad Hoc Telecommunications Users Committee comments at 11; ALLTEL comments at 16; Citizens Utilities comments at 34; Colorado Ind. Tel. Ass'n comments at 5-6; GVNW comments at 42; GTE comments at 80; Home Tel. comments at 1; Illinois Ind. Tel. Ass'n comments at 7; Minnesota Ind. Coalition comments at 14; Ohio Consumers' Counsel reply at 25-26; PacTel comments at 99; Puerto Rico Tel. reply at 16-17; Rural Tel. Coalition comments at 11-15.

[3066] Minnesota Ind. Coalition comments at 14; Western Alliance comments at 7.

[3067] Minnesota Ind. Coalition comments at 14.

[3068] Anchorage Tel.Utility comments at 2-4; Bay Springs, *et al.* comments at 10; Centennial Cellular Corp. comments at 12; Alaska Tel. Ass'n comments at 6; Matanuska Tel. Ass'n comments at 5; USTA comments at 87-93.

section 251(f).[3069]

2. Discussion

1253. We agree with parties, including small incumbent LECs, who argue that determining whether a telephone company is entitled, pursuant to section 251(f), to exemption, suspension, or modification of the requirements of section 251 generally should be left to state commissions.[3070] Requests made pursuant to section 251(f) seek to carve out exceptions to application of the section 251 rules that we are establishing in this proceeding. We find that Congress intended the section 251 requirements, and the Commission's implementing rules thereunder, to apply to all carriers throughout the country, except in the circumstances delineated in the statute. We find convincing assertions that it would be an overwhelming task at this time for the Commission to try to anticipate and establish national rules for determining when our generally-applicable rules should *not* be imposed upon carriers. Therefore, we establish in this Order a very limited set of rules that will assist states in their application of the provisions in section 251(f).

1254. Many parties have proposed varying interpretations of the provisions in section 251(f), and have asked for Commission determination or a statement of agreement. Because it appears that many parties welcome some guidance from the Commission, we briefly set forth our interpretation of certain provisions of section 251(f). Such statements will assist parties and, in particular, state commissions that must make determinations regarding requests for exemption, suspension, and modification.

C. APPLICATION OF SECTION 251(f)

1. Comments

1255. Some commenters urge the Commission to require states to grant exemptions, suspensions, or modifications only on a case-by-case basis, and only to the extent warranted by the particular circumstances. They ask the Commission to prohibit states from granting broad-scale or generalized exemptions, suspensions or modifications.[3071] AT&T argues that, to ensure that states do not allow LECs to avoid the regulatory and policy framework that Congress has mandated, the Commission should clarify that states must narrowly tailor suspensions and

[3069] Kentucky Commission comments at 7; Anchorage Tel. Utility comments at 4. Several parties argue that any federal action should not be mandatory. Ohio Commission comments at 80; Citizens Utilities comments at 33; Colorado Ind. Tel. Ass'n comments at 6; Rural Tel. Coalition reply at 18-19.

[3070] *See, e.g.*, Minnesota Ind. Coalition comments at 14; Rural Tel. Coalition comments at 11.

[3071] *See, e.g.*, Centennial Cellular Corp. comments at 16; NCTA comments at 64; Vanguard reply at 21-22.

modifications to protect against specific, identifiable harm.[3072] Telecommunications Carriers for Competition and GCI argue that section 251(f) allows states to delay imposing the requirements under section 251(b) and (c), but it does not allow states to protect LECs from those requirements indefinitely.[3073] In response, Rural Tel. Coalition and SNET state that, while the term "suspensions" could be interpreted as allowing a time delay in implementation, the addition of the term "modifications" allows states to act more broadly.[3074] SNET favors allowing the states "broad discretion to change the nature of any requirement imposed by subsections (b) and (c)."[3075] USTA argues that states should not be permitted to eliminate all exemptions for all carriers.[3076]

1256. A number of parties allege that the Commission should encourage or require states to establish a legal presumption that the LEC seeking an exemption, suspension, or modification must prove to the state commission that such request is merited under the criteria set forth in section 251(f). AT&T argues that a carrier petitioning for suspension or modification under section 251(f)(2) should be obliged to demonstrate that "the application to it of the [s]ection 251(b) or (c) obligations that are the subject of its petition would inflict substantial harm on the LEC and customers in its territories that would not be inflicted on larger LECs and customers in their territories."[3077] SCBA asserts that the burden should be upon the incumbent LEC, which has strong disincentives to promote competitive entry.[3078] Local exchange carriers contend, on the other hand, that the party making a request under section 251(b) or (c) should have to prove that an exemption, suspension, or modification is not justified. For example, TCA, Inc. argues that, because of the high cost of providing telephone service in rural areas, competing carriers should be required to prove that competition will benefit a given rural area.[3079] Bay Springs, *et al.* and Bogue, Kansas argue that rural carriers should benefit from a presumption that they continue to qualify for the exemption in section 251(f)(1).[3080] SNET suggests that, if a LEC makes a *prima*

[3072] AT&T comments at 90-93; *accord* Ohio Consumers' Counsel reply at 26.

[3073] GCI comments at 16-19; TCC comments at 51-53, reply at 28.

[3074] Rural Tel. Coalition reply at 19-20; SNET comments at 36-37.

[3075] SNET comments at 36-37.

[3076] USTA comments at 87; Continental comments at 17 (citing actions of New Hampshire and Connecticut Commissions); Rural Tel. Coalition reply at 25.

[3077] AT&T comments at 92-93; *contra* Cincinnati Bell reply at 14; PacTel reply at 41; SNET reply at 8; USTA reply at 35-36.

[3078] SCBA comments at 17.

[3079] TCA comments at 10.

[3080] Bay Springs, *et al.* comments at 11; Bogue, Kansas comments at 8; *contra* Classic Tel. reply at 9.

facie case in its petition for suspension or modification, the state should automatically grant a temporary suspension of section 251(b) and (c) obligations, as allowed by section 251(f)(2).[3081]

1257. USTA, some rural LECs, and several other parties advocate that the Commission clarify what constitutes a bona fide request under section 251(f)(1).[3082] USTA recommends that a bona fide request must include, at a minimum: (1) a request for service to begin within one year from the date of the request, with a minimum one-year service period; (2) identification of the points where interconnection is sought, specification of network components and quantities needed, and the date when interconnection is desired; and (3) an indication that the requesting carrier is willing to agree to pay charges sufficient to compensate the LEC for all costs incurred in fulfilling the terms of the interconnection agreement as part of the agreement. USTA also contends that the states should be allowed to mandate longer minimum service periods and require competitive providers to post bonds or submit deposits to ensure that a rural telephone company does not bear the cost of interconnection.[3083] Anchorage Telephone Utility claims that simply responding to requests for interconnection imposes a tremendous burden and expense on rural telephone companies, and that rural LECs should not have to respond to requests that do not meet minimum criteria.[3084] Several parties state that they do not believe that generalized form letter requests should be considered a bona fide request.[3085]

1258. Other commenters either favor a broader definition of a bona fide request or oppose federal standards entirely.[3086] NCTA and GCI argue that a request for interconnection

[3081] SNET comments at 37; *see also* Anchorage Tel. Utility comments at 3-4; Cincinnati Bell comments at 41-42; USTA comments at 91-93.

[3082] Anchorage Tel. Utility comments at 5; Bay Springs, *et al.* at 10; Bogue, Kansas comments at 7; NECA comments at 12; TDS reply at 5-6; USTA comments at 87-88; *see also* Kentucky Commission comments at 7.

[3083] USTA comments at 87-88; *accord* Anchorage Tel. Utility comments at 6-7 (carriers that ultimately do not order the items identified in a request for interconnection, services, or network elements should be required to reimburse the incumbent LEC for the costs of responding to such request); Matanuska Tel. Ass'n comments at 5.

[3084] Anchorage Tel. Utility comments at 6 (reporting the receipt of two letters "purporting to request interconnection." "One is a 1-page letter that simply asserts a need for interconnection. The other is an 8-page, single-spaced letter that demands detailed technical, operational and cost information on practically every facet of Anchorage Tel. Utility's local exchange service, without providing any indication of what the requesting carrier actually plans, needs or wants"); *accord* NECA reply at 10-11 (any bona fide request standard should permit LECs to recover costs of responding to requests and enable LECs to avoid unnecessary costs in responding to requests); TDS reply at 5-6.

[3085] TDS reply at 5; Anchorage Tel. Utility comments at 6; Rural Tel. Coalition reply at 24-25.

[3086] *See, e.g.*, Louisiana Commission comments at 22-23 (opposing any attempt by the Commission to define a standard for bona fide requests); *see also* Western Alliance comments at 7 n.16.

should be presumed bona fide until a rural telephone company shows that it is not. They object to a bona fide request requirement, such as the one proposed by USTA, that includes burdensome "pre-filing" requirements as a condition for state review under section 251(f).[3087]

1259. Subsection 251(f)(2) applies to LECs "with fewer than 2 percent of the Nation's subscriber lines installed in the aggregate nationwide."[3088] Several parties suggest that the Commission clarify which carriers meet the numerical standard.[3089] AT&T and a number of other parties argue that the 2 percent should be applied at the holding company level in order to ensure that no BOC operating company can apply for a suspension or modification under this subsection.[3090] Some parties further question whether Tier 1 LECs should be allowed to petition for suspension or modification under subsection (f)(2).[3091] Other parties argue that the two percent statutory cut-off is not a loophole and that the statutory standard should not be altered by the Commission to exclude Tier 1 LECs.[3092] PacTel suggests that the standard should be applied at the operating company level because section 251(f)(2) by its terms applies to "local exchange carrier[s]" not local exchange carriers "and their affiliates."[3093]

1260. Some parties recommend that the Commission offer guidance on how to determine whether a request for exemption, modification, or suspension should be granted.[3094] For example, sections 251(f)(1) and (f)(2) both include consideration of "technical feasibility" in deciding whether to grant an exemption, suspension, or modification. Some parties urge the Commission to clarify whether the standard for determining technical feasibility for purposes of section 251(f)

[3087] NCTA comments at 26-27; GCI reply at 17-18; *but see* USTA reply at 37 (disagreeing that its proposal would constitute "pre-filing" requirements).

[3088] 47 U.S.C. § 251(f)(2).

[3089] BellSouth comments at 76; Ohio Consumers' Counsel comments at 47-48.

[3090] AT&T comments at 90-93; Lincoln Tel. reply at 9-10; GCI reply at 17; TCC reply at 28; Ohio Consumers' Counsel argues that this interpretation is sound because section 251(f)(2) discusses the number of lines "in the aggregate nationwide," and individual operating companies do not operate on a nationwide scale. Ohio Consumers' Counsel reply at 26.

[3091] AT&T comments at 92; TLD comments at 6-7; Centennial Cellular Corp. comments at 12-15.

[3092] Alaska Tel. Ass'n comments at 6; Cincinnati Bell comments at 40, reply at 13; Lincoln Tel. comments at 10-11.

[3093] PacTel reply at 40-41.

[3094] *See, e.g.*, NCTA comments at 63-67 (urging a very limited construction of the exemption, suspension and modification provisions); *contra* Western Alliance reply at 7; Rural Tel. Coalition reply at 21-22.

is different than the technical feasibility standard set forth in sections 251(b) and (c).[3095] Sections 251(f)(1) and (f)(2) require the states to consider whether a request is "unduly economically burdensome."[3096] Generally, comments from rural LECs and others contend that smaller LECs cannot afford to hire staff to respond to requests, or expend funds for additional facilities or operational systems without jeopardizing their financial stability.[3097] In contrast, other parties argue that LECs should not be relieved of any duties otherwise imposed by sections 251(b) and (c) merely because they would require the expenditure of funds.[3098]

1261. Some incumbent LECs recommend that carriers that compete with rural LECs should be required to assume some of the universal service obligations of rural carriers.[3099] They argue that, without such safeguards, competing LECs will enter rural markets and take the incumbent LECs' profitable customers. USTA argues that state commissions should be encouraged to grant waivers until universal service issues are resolved.[3100] Commenters also propose varying interpretations of what constitutes "significant adverse impact on users."[3101] USTA proposes that the definition include any request that would cause a LEC to "have difficulty raising sufficient investment capital, and where the remaining customers . . . would likely bear an increase in rates or a reduction in service to cover a shortfall or subsidy to a new entrant."[3102] TLD proposes that the Commission establish a numerical benchmark, for example, that more than 50 percent of the users would suffer a rate increase of at least 20 percent before a request would be considered in violation of subsection (f)(2)(A)(i).[3103]

3. Discussion

[3095] *See, e.g.*, Bay Springs, *et al.* comments at 11; Lincoln Tel. comments at 23-24; SNET comments at 35; USTA comments at 92; Rural Tel. Coalition reply at 22-23.

[3096] 47 U.S.C. § 251(f).

[3097] A number of parties argue that, if smaller and rural LECs cannot recover their total costs, including any required investments and costs associated with developing rate levels and modifying support systems, the request should be deemed unduly economically burdensome. *See, e.g.*, USTA comments at 92; SNET comments at 36; TLD comments at 2; Lincoln Tel. comments at 23-25; TLD comments at 11-13.

[3098] *See, e.g.*, NCTA comments at 64 n.218.

[3099] Bay Springs, *et al.* comments at 12; TLD comments at 5; *accord* NECA comments at 11.

[3100] USTA comments at 91; *but see* NCTA reply at 25-26.

[3101] 47 U.S.C. § 251(f)(2)(A)(i).

[3102] USTA comments at 92.

[3103] TLD comments at 11.

1262. Congress generally intended the requirements in section 251 to apply to carriers across the country, but Congress recognized that in some cases, it might be unfair or inappropriate to apply all of the requirements to smaller or rural telephone companies.[3104] We believe that Congress intended exemption, suspension, or modification of the section 251 requirements to be the exception rather than the rule, and to apply only to the extent, and for the period of time, that policy considerations justify such exemption, suspension, or modification. We believe that Congress did not intend to insulate smaller or rural LECs from competition, and thereby prevent subscribers in those communities from obtaining the benefits of competitive local exchange service. Thus, we believe that, in order to justify continued exemption once a bona fide request has been made, or to justify suspension, or modification of the Commission's section 251 requirements, a LEC must offer evidence that application of those requirements would be likely to cause undue economic burdens beyond the economic burdens typically associated with efficient competitive entry. State commissions will need to decide on a case-by-case basis whether such a showing has been made.

1263. Given the pro-competitive focus of the 1996 Act, we find that rural LECs must prove to the state commission that they should continue to be exempt pursuant to section 251(f)(1) from requirements of section 251(c), once a bona-fide request has been made, and that smaller companies must prove to the state commission, pursuant to section 251(f)(2), that a suspension or modification of requirements of sections 251(b) or (c) should be granted. We conclude that it is appropriate to place the burden of proof on the party seeking relief from otherwise applicable requirements. Moreover, the party seeking exemption, suspension, or modification is in control of the relevant information necessary for the state to make a determination regarding the request. A rural company that falls within section 251(f)(1) is not required to make any showing until it receives a bona fide request for interconnection, services, or network elements. We decline at this time to establish guidelines regarding what constitutes a bona fide request. We also decline in this Report and Order to adopt national rules or guidelines regarding other aspects of section 251(f). For example, we will not rule in this proceeding on the universal service duties of requesting carriers that seek to compete with rural LECs. We may offer guidance on these matters at a later date, if we believe it is necessary and appropriate.

1264. We find that Congress intended section 251(f)(2) only to apply to companies that, at the holding company level, have fewer than two percent of subscriber lines nationwide. This is consistent with the fact that the standard is based on the percent of subscriber lines that a carrier has "*in the aggregate nationwide*."[3105] Moreover, any other interpretation would permit almost any company, including Bell Atlantic, Ameritech, and GTE affiliates, to take advantage of the suspension and modification provisions in section 251(f)(2). Such a conclusion would render the two percent limitation virtually meaningless.

[3104] 47 U.S.C. § 251(f).

[3105] 47 U.S.C. 251(f)(2) (emphasis added).

1265. We note that some parties recommend that, in adopting rules pursuant to section 251, the Commission provide different treatment or impose different obligations on smaller or rural carriers.[3106] We conclude that section 251(f) adequately provides for varying treatment for smaller or rural LECs where such variances are justified in particular instances. We conclude that there is no basis in the record for adopting other special rules, or limiting the application of our rules to smaller or rural LECs.

[3106] For example, the Rural Tel. Coalition argues that interconnection and collocation points should be set in a flexible manner to take into account size and volume differences among carriers. Rural Tel. Coalition comments at 31.

XIII. ADVANCED TELECOMMUNICATIONS CAPABILITIES

1266. Section 706(a) provides that the Commission "shall encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans (including, in particular, elementary and secondary schools and classrooms) by utilizing, in a manner consistent with the public interest, convenience, and necessity, price cap regulation, regulatory forbearance, measures that promote competition in the local telecommunications market, or other regulating methods that remove barriers to infrastructure investment."[3107] In the NPRM, we sought comment on how we can advance Congress's section 706(a) goal within the context of our implementation of sections 251 and 252.[3108]

1267. A number of parties suggest that rules allowing them to compete effectively and earn a profit in the telecommunications industry would assist the industry in providing telecommunications services to all Americans.[3109] MFS suggests that "all LECs should be required, as a condition of eligibility for universal service subsidies, to meet network modernization standards for rural telephone companies."[3110] Several state commissions indicate that they have already established programs to assist institutions eligible under section 706 in deploying advanced telecommunications services.[3111] The Alliance for Public Technology asserts that section 706 should underlie all of the FCC's proceedings.[3112] Ericsson states that the industry should work with government agencies to promote leading edge technology to ensure that it is introduced on a reasonably timely basis. For example, it contends that "Plug and Play Internet use" will greatly help the public and schools access information, and that advanced technology such as asynchronous transfer mode (ATM), wireless data/video, and AIN will enhance interconnection capabilities of public and private networks.[3113] The Illinois Commission contends that, depending on the pricing standard the Commission adopts for interconnection and access to unbundled elements, and the Commission's interpretation of the prohibition against discrimination, the Commission should adopt special rules for carriers when they provide interconnection or access to unbundled network elements to serve a school, library, or healthcare

[3107] 47 U.S.C. § 706(a).

[3108] NPRM at para. 263.

[3109] Colorado Ind.Tel. Ass'n comments at 6; COMAV comments at 60-61; GVNW comments at 42; Illinois Ind. Tel. Ass'n comments at 7; Louisiana Commission comments at 24-27.

[3110] MFS comments at 88.

[3111] Illinois Commission comments at 85; Louisiana Commission comments at 24-27; Texas Commission comments at 36.

[3112] Alliance for Public Technology reply at 1-5.

[3113] Ericsson comments at 7-8.

provider.[3114]

1268. We decline to adopt rules regarding section 706 in this proceeding. We intend to address issues related to section 706 in a separate proceeding.

[3114] Illinois Commission comments at 86.

XIV. PROVISIONS OF SECTION 252

A. Section 252(e)(5)

1. Background

1269. Section 252(e)(5) directs the Commission to assume responsibility for any proceeding or matter in which the state commission "fails to act to carry out its responsibility" under section 252.[3115] In the NPRM, we asked whether the Commission should establish rules and regulations necessary to carry out our obligation under section 252(e)(5).[3116] In addition, we sought comment on whether in this proceeding we should establish regulations necessary and appropriate to carry out our obligations under section 252(e)(5). In particular, we sought comment on what constitutes notice of failure to act, what procedures, if any, we should establish for parties to notify the Commission, and what are the circumstances under which a state commission should be deemed to have "fail[ed] to act" under section 252(e)(5).[3117]

1270. Section 252(e)(4) provides that, if the state commission does not approve or reject (1) a negotiated agreement within 90 days, or (2) an arbitrated agreement within 30 days, from the time the agreement is submitted by the parties, the agreement shall be "deemed approved."[3118] We sought comment on the relationship between this provision and our obligation to assume responsibility under section 252(e)(5). We also sought comment on whether the Commission, once it assumes the responsibility of the state commission, is bound by all of the laws and standards that would have applied to the state commission, and whether the Commission is authorized to determine whether an agreement is consistent with applicable state law as the state commission would have been under section 252(e)(3).[3119] In addition, we sought comment on whether, once the Commission assumes responsibility under section 252(e)(5), it retains jurisdiction, or whether that matter or proceeding subsequently should be remanded to the state.

1271. Finally, we sought comment on whether we should adopt, in this proceeding, some standards or methods for arbitrating disputes in the event we must conduct an arbitration under section 252(e)(5). We noted some of the benefits and drawbacks of both "final offer" arbitration and open-ended arbitration, and asked for comment on both.

[3115] 47 U.S.C. § 252(e)(5).

[3116] NPRM at ¶ 265.

[3117] NPRM at ¶ 266.

[3118] 47 U.S.C. § 252(e)(4).

[3119] NPRM at ¶ 267.

2. Comments

1272. The majority of the parties that commented on this issue assert that the Commission should establish guidelines under which it will carry out its responsibilities under section section 252(e)(5).[3120] The Illinois Commission, for example, argues that regulations are needed in order to avoid jurisdictional disputes that may arise.[3121] Some parties, on the other hand, argue that it is not critical for the Commission at this time to develop rules governing the arbitration process.[3122] The Pennsylvania Commission, for example, argues that such rules should be adopted in this proceeding only if the Commission perceives a real possibility that it will be asked in the near future to arbitrate an interconnection agreement.[3123]

1273. A broad range of parties comment on what constitutes a "failure to act" and whether the Commission should establish a definition and procedures for interested parties to notify us if a state commission fails to act.[3124] The Illinois Commission, for example, argues that, upon receipt of a petition to mediate or arbitrate, or a BOC statement of generally available terms, the state commission should issue and serve upon the Commission a notice of its intent to act. This will put the Commission and interested parties on notice that the state commission intends to act.[3125] Some state commissions argue that "failure to act" occurs only if the state commission fails to respond to a request for mediation or arbitration, or fails to issue an arbitration decision within nine months after the incumbent LEC receives a request for interconnection under section 252.[3126]

1274. Other parties contend that failure to act should mean that a state commission has

[3120] *See, e.g.*, Jones Intercable comments at 16-18; California Commission comments at 49; Illinois Commission comments at 87; MCI comments at 94-95; BellSouth comments at 78; Cable & Wireless comments at 50-51; Time Warner comments at 104-105; Oregon Commission comments at 4.

[3121] Illinois Commission comments at 87.

[3122] *See, e.g.*, Pennsylvania Commission comments at 42; PacTel comments at 99; Iowa Commission comments at 7; GTE comments at 80-81.

[3123] Pennsylvania Commission comments at 42.

[3124] *See, e.g.*, Illinois Commission comments at 89; District of Columbia comments at 40; Ohio Commission comments at 81-82; Time Warner comments at 106-107; PacTel comments at 99; Jones Intercable comments at 16 (failure to act occurs where a state fails to respond to a request for arbitration or fails to render a decision on time in arbitration).

[3125] Illinois Commission comments at 89.

[3126] District of Columbia Commission comments at 40; Ohio Commission comments at 81-82; *accord* Cable & Wireless comments at 51.

not taken any steps to act upon a request for arbitration, or has not taken any steps to approve an arbitrated agreement within the time set out in section 252(e)(4).[3127] Jones argues that a failure to act occurs where a state fails to respond to a request for arbitration or fails to render a decision on time in the arbitration proceeding.[3128] Ohio Consumers' Counsel contends that failure to carry out a state's responsibility means more than mere inaction, and that, for example, willfully disregarding the standards in section 252(e)(2) for approving or disapproving agreements might also "constitute a failure to act to carry out its responsibility" under section 252.[3129] USTA argues that, where there has been no agreement and the state fails to act, the Commission must step in and, in some instances, the Commission may need to step in to arbitrate or mediate before an agreement has been reached.[3130]

1275. Regarding the relationship between sections 252(e)(5) and 252(e)(4), most commenters assert that, if a state fails to approve a negotiated agreement within 90 days, or an arbitrated agreement within 30 days, the agreement will be deemed approved, and no Commission action is required.[3131] These parties contend that approval or disapproval of negotiated or arbitrated agreements are not reviewable by the Commission, but that aggrieved parties may seek relief in the appropriate federal district court.

1276. A number of commenters believe that it is important that procedures be in place for interested parties to notify the Commission if a state fails to act. These parties argue that notice of failure to act should be in writing, and should contain the relevant factual circumstances including the provision of the statute under which the state allegedly has failed to act.[3132] They contend that notice should be given to allow interested parties and the state adequate time to respond. MCI asserts that existing Commission procedures are adequate. MCI argues that any notice of an alleged state commission failure to act should set forth relevant facts and the

[3127] *See, e.g.*, Oregon Commission comments at 4; California Commission comments at 47; Ohio Consumers' Counsel comments at 49; Texas Commission comments at 36-37.

[3128] Jones Intercable comments at 16.

[3129] Ohio Consumers' Counsel comments at 49; *see also* California Commission comments at 48 (an agreement automatically approved because the state did not act within the specified time frame should not be deemed to be in compliance with state law).

[3130] USTA comments at 93-94.

[3131] *See, e.g.*, USTA comments at 93-94; Illinois Commission comments at 88; BellSouth comments at 79; Jones Intercable comments at 15; Time Warner reply at 106-107; PacTel comments at 99.

[3132] *See, e.g.*, Ohio Commission comments at 81; Ohio Consumers' Counsel comments at 49; Illinois Commission comments at 89-90.

Commission should place the item on public notice.[3133]

1277. A majority of the commenting parties argue that, if the Commission assumes the responsibility of a state commission, it should be bound by laws and standards that would have applied to the state commission.[3134] These parties allege that this approach would produce consistent results, and that Congress did not intend to create another forum with a separate set of rules. Time Warner, on the other hand, argues against the Commission being bound by state law.[3135]

1278. Parties disagree over whether authority would revert back to the states once the Commission assumes a state commission's responsibility. A number of state commissions argue that the Commission does not retain jurisdiction; it only assumes jurisdiction over a particular proceeding or matter but does not substitute for the state commission on an ongoing basis.[3136] The District of Columbia Commission asserts that, at any time, the state should be able to petition the Commission to reconsider its decision to preempt, and such petitions should be granted upon a reasonable assurance the state intends to carry out its obligations.[3137] A number of parties contend that, once the Commission assumes jurisdiction over a proceeding or matter, it should retain jurisdiction.[3138] Teleport, for example, argues that the Commission "should not risk returning jurisdiction to a state that has demonstrated an ineptitude for implementing interconnection agreements."[3139] Pacific Telesis and Cable and Wireless argue that any agreement arbitrated by the Commission must be submitted to the state for approval.[3140]

[3133] MCI comments at 95.

[3134] *See, e.g.*, PacTel comments at 13-14 (if there is any conflict between the Commission's own rules and requirements of that state, the Commission must lay aside its rules and enforce the state's); California Commission comments at 48; Illinois Commission comments at 90; BellSouth comments at 79; Ohio Commission comments at 82; Louisiana Commission comments at 28 (specific questions concerning a state's law could be certified to the state); SBC comments at 105.

[3135] Time Warner comments at 107-108 (the Commission's authority to interpret state law is suspect, and the Commission lacks the resources and expertise to sit as a trier of law in fifty jurisdictions).

[3136] *See, e.g.*, Ohio Commission comments at 81; Louisiana Commission comments at 28; Pennsylvania Commission comments at 43; District of Columbia Commission comments at 40-41; BellSouth comments at 80.

[3137] District of Columbia Commission comments at 40-41.

[3138] *See, e.g.*, Teleport comments at 89; Jones Intercable comments at 17; Time Warner comments at 109; Oregon Commission comments at 5 (failure by the state to act on one agreement should not vest jurisdiction over other agreements or matters).

[3139] Teleport comments at 89.

[3140] PacTel comments at 100; Cable & Wireless comments at 52.

1279. The vast majority of commenters recommend that the Commission adopt standards for arbitrating disputes in the event that it assumes responsibility under section 252(e)(5).[3141] These parties assert that sufficiently detailed rules should ensure fair and expeditious handling of arbitrations. A few of the commenters favor national rules governing state arbitration proceedings.[3142] SCBA, for example, favors national standards requiring state commissions to use abbreviated, lower cost arbitration proceedings for small cable operators.[3143] The majority of commenters, however, argue against national rules that would govern state arbitration proceedings.[3144]

1280. There is also significant disagreement regarding whether final-offer arbitration should be the arbitration model adopted by the Commission in the event the Commission must conduct the arbitration itself. A broad range of parties argue that final offer arbitration would result in reasonable recommendations to the arbitrator.[3145] Vanguard argues that the "final offer" method of arbitration should permit post-offer negotiation by the parties and allow the parties to tailor counter-proposals.[3146] Under this approach, the Commission would permit negotiation to continue after arbitration offers are exchanged in order to promote negotiated settlements.[3147]

1281. Many competitors oppose a "final offer" arbitration standard.[3148] Sprint, for example, argues that "final-offer" arbitration works well when there is a single, narrowly defined issue on the table, but, where there are numerous complex technical and economic issues, confronting the arbitrator with an "either/or" choice leaves insufficient flexibility to achieve a

---

[3141] *See, e.g.*, Teleport comments at 85-86; MFS comments at 89-90; CompTel comments at 108; MCI comments at 95-96; Ohio Consumers' Counsel comments at 50; SBC comments at 99; Kentucky Commission comments at 7; Ohio Commission comments at 83; Illinois Commission comments at 91; Timer Warner comments at 109; Jones Intercable comments at 18; Vanguard comments at 35-37; Association of Telemessaging Services International reply at 18.

[3142] *See, e.g.*, Vanguard comments at 35-37; Time Warner comments at 109.

[3143] SCBA comments at 11-12.

[3144] *See, e.g.*, Oregon Commission reply at 11; Ohio Commission comment at 81; NARUC reply at 14; Illinois Commission at 91.

[3145] *See, e.g.*, Teleport comments at 88; USTA comments at 94-95; SBC comments at 103;

[3146] Vanguard comments at 39-40.

[3147] *Id.* at 40.

[3148] *See, e.g.*, MCI comments at 95-96; Sprint reply at 47; Time Warner comments at 111; Competitive Policy Institute reply at 21-22; GCI reply at 5.

result that comports with section 251.[3149] In addition, Sprint asserts that, because arbitration proceedings have a public interest component that sets them apart from mere private disputes, neither party's offer might serve the public interest.[3150] Some parties recommend an "open-ended" arbitration system,[3151] while California is in favor of a hybrid between the two. [3152]

1282. SBC contends that Congress did not intend for arbitration to be binding to the extent that parties are not legally obligated to enter into an agreement after the arbitrator issues a decision.[3153] SBC argues that parties are bound by the arbitrator's decision only if they decide to enter into an agreement. Vanguard responds that SBC's proposal is contrary to the statute, which does not give parties the opportunity to reject the results of arbitration and which does not provide for *de novo* review.[3154]

3. Discussion

1283. After careful review of the record, we are convinced that establishing regulations to carry out our obligations under section 252(e)(5) will provide for an efficient and fair transition from state jurisdiction should we have to assume the responsibility of the state commission under Section 252(e)(5). The rules we establish in this section with respect to arbitration under section 252 apply only to instances where the Commission assumes jurisdiction under section 252(e)(5); we do not purport to advise states on how to conduct arbitration when the Commission has not assumed jurisdiction. The rules we establish will give notice of the procedures and standards the Commission would apply to mediation and arbitration, avoid delay if the Commission had to arbitrate disputes in the near future, and may also offer guidance the states may, at their discretion, wish to consider in implementing their own mediation and arbitration procedures and standards. We decline to adopt national rules governing state arbitration procedures. We believe the states are in a better position to develop mediation and arbitration rules that support the objectives of the 1996 Act. States may develop specific measures that address the concerns of

[3149] Sprint reply at 47.

[3150] *Id.*

[3151] *See, e.g.*, Time Warner comments at 111.

[3152] California Commission comments at 50. The California Commission's procedures for resolving interconnection disputes is based on a four-step expedited dispute resolution process for resolving disputes between parties who cannot agree on the terms of interconnection. Step 1 is informal resolution without state intervention. Step 2 provides for dispute resolution with mediation by the Administrative Law Judge (ALJ). Step 3 calls for the parties to submit short pleadings to the ALJ who shall use the state commission's "preferred outcomes" approach as a guideline in resolving dispute. Step 4 allows for a party to challenge an ALJ ruling by filing an expedited complaint.

[3153] SBC comments at 99.

[3154] Vanguard reply at 18-20; *accord* Competition Policy Institute reply at 18-19.

small entities and small incumbent LECs participating in mediation or arbitration.

1284. The rules we adopt herein are minimum, interim procedures. Adopting minimum interim procedures now will allow the Commission to learn from the initial experiences and gain a better understanding of what types of situations may arise that require Commission action. We note that the Commission is not required to adopt procedures and standards for mediation and arbitration within the six-month statutory deadline and that, by adopting minimum interim procedures, the Commission can better direct its resources to more pressing matters that fall within the six-month statutory deadline.

1285. Regarding what constitutes a state's "failure to act to carry out its responsibility under" section 252,[3155] the Commission was presented with numerous options. The Commission will not take an expansive view of what constitutes a state's "failure to act." Instead, the Commission interprets "failure to act" to mean a state's failure to complete its duties in a timely manner. This would limit Commission action to instances where a state commission fails to respond, within a reasonable time, to a request for mediation or arbitration, or fails to complete arbitration within the time limits of section 252(b)(4)(C).[3156] The Commission will place the burden of proof on parties alleging that the state commission has failed to respond to a request for mediation or arbitration within a reasonable time frame. We note the work done by states to date in putting in place procedures and regulations governing arbitration and believe that states will meet their responsibilities and obligations under the 1996 Act.[3157]

1286. We agree with the majority of commenters that argue that our authority to assume the state commission's responsibilities is not triggered when an agreement is "deemed approved" under section 252(e)(4) due to state commission inaction. Section 252(e)(4) provides for automatic approval if a state fails to approve or reject a negotiated or arbitrated agreement within 90 days or 30 days, respectively. Rules of statutory construction require us to give meaning to all provisions and to read provisions consistently, where it is possible to do so. We thus conclude that the most reasonable interpretation is that automatic approval under section 252(e)(4) does not constitute a failure to act.

1287. We also believe that we should establish interim procedures for interested parties to notify the Commission that a state commission has failed to act under section 252. We believe that parties should be required to file a detailed written petition, backed by affidavit, that will, at

[3155] 47 U.S.C. § 252(e)(5).

[3156] 47 U.S.C. § 252(b)(4)(C).

[3157] *See, e.g., In the Matter of the Implementation of the Mediation and Arbitration Provisions of the Federal Telecommunications Act of 1996*, Case No. 96-463-TP-UNC, Ohio Commission, (May 30, 1996); *Illinois Commerce Commission On Its Own Motion Adoption of 83 Ill. Adm. Code 761 to Implement the Arbitration Provisions of Section 252 of the Telecommunications Act of 1996*, Docket No. 96-0297, Illinois Commission (June 14, 1996).

the outset, give the Commission a better understanding of the issues involved and the action, or lack of action, taken by the state commission. Allowing less detailed notification increases the likelihood that frivolous requests will be made. With less detailed notification, the Commission's investigations would be broader and more burdensome. A detailed written petition will facilitate a decision about whether the Commission should assume jurisdiction based on section 252(e)(5).

1288. The moving party should submit a petition to the Secretary of the Commission stating with specificity the basis for the petition and any information that supports the claim that the state has failed to act, including, but not limited to the applicable provision(s) of the Act and the factual circumstances which support a finding that a state has failed to act. The moving party must ensure that the applicable state commission and the parties to the proceeding or matter for which preemption is sought are served with the petition on the same date the party serves the petition on the Commission. The petition will serve as notice to parties to the state proceeding and the state commission who will have fifteen days from the date the petition is filed with the Commission to comment. Under section 252(e)(5), the Commission must "issue an order preempting the state commission's jurisdiction of that proceeding or matter" no later than 90 days from the date the petition is filed.[3158] If the Commission takes notice, as section 252(e)(5) permits, that a state commission has failed to act, it will, on its own motion, issue a public notice and provide fifteen days for interested parties to submit comment on whether the Commission should assume responsibility under section 252(e)(5).

1289. If the Commission assumes authority under section 252(e)(5), the Commission must also decide whether it retains authority for that proceeding or matter. We agree with those parties who argue that, once the Commission assumes jurisdiction of a proceeding or matter, it retains authority for that proceeding or matter. For example, if the Commission obtains jurisdiction after a state commission fails to respond to a request for arbitration, the Commission maintains jurisdiction over the arbitration proceeding. Therefore, once the proceeding is before the Commission, any and all further action regarding that proceeding or matter will be before the Commission. We note that there is no provision in the Act for returning jurisdiction to the state commission; moreover, the Commission, with significant knowledge of the issues at hand, would be in the best position efficiently to conclude the matter. Thus, as both a legal and policy matter, we believe that the Commission retains jurisdiction over any matter and proceeding for which it assumes responsibility under Section 252(e)(5).

1290. We reject the suggestion by some parties that, once the Commission has mediated or arbitrated an agreement, the agreement must be submitted to the state commission for approval under state law. We note that section 252(e)(5) provides for the Commission to "assume the responsibility of the State commission under this section with respect to the proceeding or matter

[3158] 47 U.S.C. § 252(e)(5).

and act for the State commission."[3159] This includes acting for the state commission under section 252(e)(1), which calls for state commission approval of "any interconnection agreement adopted by negotiation or arbitration."[3160] We, therefore, do not read section 252(e)(1) or any other provision as calling for state commission approval or rejection of agreements mediated or arbitrated by the Commission. In those instances where a state has failed to act, the Commission acts on behalf of the state and no additional state approval is required.

1291. Requirements set forth in section 252(c) for arbitrated agreements would apply to arbitration conducted by the Commission. We see no reason, and no party has suggested a policy or legal basis, for not applying such standards when the Commission conducts arbitration. Thus, arbitrated agreements must: (1) meet the requirements of section 251, including regulations prescribed by the Commission pursuant to section 251; (2) establish any rates for interconnection, services, or network elements according to section 252(d); and (3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.[3161] We reject the suggestion made by some parties that, if the Commission steps into the state commission role, it is bound by state laws and standards that would have applied to the state commission. While states are permitted to establish and enforce other requirements, these are not binding standards for arbitrated agreements under section 252(c). Moreover, the resources and time potentially needed to review adequately and interpret the different laws and standards of each state render this suggestion untenable. Finally, we conclude that it would not make sense to apply to the Commission the timing requirements that section 252(b)(4)(c) imposes on state commissions. The Commission, in some instances, might not even assume jurisdiction until nine months (or more) have lapsed since a section 251 request was initiated.

1292. Based on the comments of the parties, we conclude that a "final offer" method of arbitration, similar to the approach recommended by Vanguard, would best serve the public interest.[3162] Under "final offer" arbitration, each party to the negotiation proposes its best and final offer and the arbitrator determines which of the proposals become binding. The arbitrator would have the option of choosing one of the two proposals in its entirety, or the arbitrator could decide on an issue-by-issue basis. Each final offer must: (1) meet the requirements of section 251, including the Commission's rules thereunder; (2) establish rates for interconnection, services, or network elements according to section 252(d); and (3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.[3163] If a final offer submitted by one

[3159] 47 U.S.C. § 252(e)(5).

[3160] 47 U.S.C. § 252(e)(1).

[3161] 47 U.S.C. § 252(c).

[3162] Vanguard comments at 39-40.

[3163] 47 U.S.C. § 252(c).

or more parties fails to comply with these requirements, the arbitrator would have discretion to take steps designed to result in an arbitrated agreement that satisfies the requirements of section 252(c), including requiring parties to submit new final offers within a time frame specified by the arbitrator, or adopting a result not submitted by any party that is consistent with the requirements in section 252(c).

1293. The parties could continue to negotiate an agreement after they submit their proposals and before the arbitrator makes a decision. Under this approach, the Commission will encourage negotiations, with or without the assistance of the arbitrator, to continue after arbitration offers are exchanged. Parties are not precluded from submitting subsequent final offers following such negotiations. We believe that permitting post-offer negotiations will increase the likelihood that the parties will reach consensus on unresolved issues. In addition, permitting post-offer negotiations will increase flexibility and will allow parties to tailor counter-proposals after arbitration offers are exchanged. To provide an opportunity for final post-offer negotiation, the arbitrator will not issue a decision for at least 15 days after submission of the final offers by the parties. In addition, the offers must be consistent with section 251, including the regulations prescribed by the Commission. We reject SBC's suggestion that an arbitrated agreement is not binding on the parties. Absent mutual agreement to different terms, the decision reached through arbitration is binding. We conclude that it would be inconsistent with the 1996 Act to require incumbent LECs to provide interconnection, services, and unbundled elements, impose a duty to negotiate in good faith and a right to arbitration, and then permit incumbent LECs to not be bound by an arbitrated determination. We also believe that, although competing providers do not have an affirmative duty to enter into agreements under section 252, a requesting carrier might face penalties if, by refusing to enter into an arbitrated agreement, that carrier is deemed to have failed to negotiate in good faith.[3164] Such penalties should serve as a disincentive for requesting carriers to force an incumbent LEC to expand resources in arbitration if the requesting carrier does not intend to abide by the arbitrated decision.

1294. Adopting a "final offer" method of arbitration and encouraging negotiations to continue allows us to maintain the benefits of final offer arbitration, giving parties an incentive to submit realistic "final offers," while providing additional flexibility for the parties to agree to a resolution that best serves their interests. To the extent that these procedures encourage parties to negotiate voluntarily rather than arbitrate, such negotiated agreements will be subject to review pursuant to section 252(e)(2)(A), which would allow the Commission to reject agreements if they are inconsistent with the public interest. This approach also addresses the argument that under "final offer" arbitration neither offer might best serve the public interest, because it allows the parties to obtain feedback from the arbitrator on public interest matters.

1295. We believe that the arbitration proceedings generally should be limited to the requesting carrier and the incumbent local exchange provider. This will allow for a more

[3164] *See* 47 U.S.C. § 252(b)(5) (requiring parties to negotiate in good faith in the course of arbitration).

efficient process and minimize the amount of time needed to resolve disputed issues. We believe that opening the process to all third parties would be unwieldy and would delay the process. We will, however, consider requests by third parties to submit written pleadings. This may, in some instances, allow interested parties to identify important public policy issues not raised by parties to an arbitration.

B. Requirements of Section 252(i)

1. Background

1296. Section 251 requires that interconnection, unbundled element, and collocation rates be "nondiscriminatory" and prohibits the imposition of "discriminatory conditions" on the resale of telecommunications services.[3165] Section 252(i) of the 1996 Act provides that a "local exchange carrier shall make available any interconnection, service, or network element provided under an agreement approved under [section 252] to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement."[3166] In the NPRM, we expressed the view that section 252(i) appears to be a primary tool of the 1996 Act for preventing discrimination under section 251, and we sought comment on whether we should adopt national standards for resolving disputes under section 252(i) in the event that we must assume the state's responsibilities pursuant to section 252(e)(5). In addition, because we may need to interpret section 252(i) if we assume the state commission's responsibilities, we sought comment on the meaning of section 252(i).

1297. We also sought comment in the NPRM on whether section 252(i) requires that only similarly-situated carriers may enforce against incumbent LECs provisions of agreements filed with state commissions, and, if so, how "similarly-situated carrier" should be defined. In particular, we asked whether section 252(i) requires that the same rates for interconnection must be offered to all requesting carriers regardless of the cost of serving that carrier, or whether it would be consistent with the statute to permit different rates if the costs of serving carriers are different. We also asked whether the section can be interpreted to allow incumbent LECs to make available interconnection, services, or network elements only to requesting carriers serving a comparable class of subscribers or providing the same service (*i.e.*, local, access, or interexchange) as the original parties to the agreement. In the NPRM, we tentatively concluded that the language of the statute appears to preclude such differential treatment among carriers.

[3165] 47 U.S.C. §§ 251(c)(2)(D) (interconnection rates, terms, and conditions); 251(c)(3) (unbundled network elements rates, terms, and conditions); 251(c)(6) (collocation rates, terms, and conditions); and 251(c)(4)(B) (resale). Section 252(d)(1) also requires nondiscriminatory interconnection and network element charges. 47 U.S.C. § 252(d)(1).

[3166] 47 U.S.C. § 252(i).

1298. Additionally, we sought comment in the NPRM on whether section 252(i) permits requesting telecommunications carriers to choose among individual provisions of publicly-filed interconnection agreements or whether they must subscribe to an entire agreement. We also sought comment regarding what time period an agreement must remain available for use by other requesting telecommunications carriers.

2. Comments

1299. Two state commissions and SBC believe that implementation of section 252(i) should be left to the states,[3167] while Time Warner favors national standards.[3168] CompTel argues that we should adopt expedited procedures whereby carriers may complain to the Commission when incumbent LECs refuse to make agreements available to them in alleged violation of section 252(i).[3169]

1300. New entrants generally support the view that section 252(i) does not require that requesting carriers seeking to avail themselves of a prior negotiated or arbitrated agreement be "similarly situated" with respect to the original party who negotiated the agreement.[3170] They argue that such a limitation would be contrary to Congress's intent,[3171] or that it could invite perpetual dispute over which carriers are similarly situated and what cost differences are real and material.[3172] Winstar questions whether states could implement a "similarly situated" carrier requirement without unintentionally creating a vehicle for incumbent LECs to discriminate against competitive entrants.[3173] LDDS specifically agrees with the NPRM's tentative conclusion that section 252(i) prohibits incumbent LECs from limiting the availability of agreements to a carrier based on the class of customers the carrier serves or the type of service it provides.[3174] The

[3167] Pennsylvania Commission comments at 43; Louisiana Commission comments at 28-29; SBC Comments at 24.

[3168] Time Warner comments at 112.

[3169] CompTel comments at 107.

[3170] WinStar comments at 18-19; CompTel comments at 106; LDDS comments at 88; Time Warner comments at 113; ACSI reply at 23-24; Telecommunications Resellers Ass'n comments at 50.

[3171] CompTel comments at 106; LDDS comments at 88; Time Warner comments at 113. CompTel also asserts that, subject to cost-based deviations, no carrier should pay more than any other carrier when it purchases the same service or facility from the same incumbent LEC, nor should agreements include language regarding the nature of the carrier who may subsequently emer into the same agreements. CompTel comments at 106.

[3172] Telecommunications Resellers Ass'n comments at 50-51.

[3173] WinStar comments at 18-19.

[3174] LDDS comments at 88.

Telecommunications Resellers Ass'n believes section 252(i) prohibits discrimination on the basis of the cost of serving a carrier, and claims its members have been, and continue to be, denied preferred service offerings and price points in the interexchange market under the guise of a "similarly situated" criterion.[3175]

1301. WinStar suggests we assign to the incumbent LEC a heavy burden of proving that a new carrier is substantially different from the original parties to an agreement, and that we require the incumbent LEC to provide service to the new entrant according to the individual terms of an agreement while the dispute is pending. WinStar asserts that, absent such requirements, the incumbent LEC could use alleged technological differences to create barriers to entry.[3176]

1302. GTE, PacTel, USTA, BellSouth, and the Ohio Consumers' Counsel believe the statute contemplates drawing distinctions between carriers,[3177] such as, for instance, where the incumbent LEC faces different costs in serving different carriers.[3178] According to GTE and PacTel, carriers must be "similarly situated" because the subsequent carrier's technical requirements may be incompatible with the incumbent LEC's network.[3179] GTE asserts that providing service under an agreement to carriers that are not similarly situated with respect to the technical feasibility and costs of interconnection and transport and termination would be inconsistent with the 1996 Act's requirements that interconnection be technically feasible and offered at cost-based rates.[3180]

1303. Incumbent LECs also generally oppose the view that section 252(i) permits competitive carriers to choose among provisions in a publicly-filed interconnection agreement.[3181] For instance, BellSouth contends that the text of section 252(i) supports its view, and that the legislative history reference cited in the NPRM casts no light on Congress' intent because the

[3175] Telecommunications Resellers Ass'n comments at 50-51.

[3176] WinStar comments at 19 n.14. WinStar further suggests that the LEC should be required to adjust the arrangement to account for differences in technology employed by the new entrant, without revising material terms of the arrangement. *Id.*

[3177] GTE comments at 82-83; PacTel comments at 101; USTA comments at 95-96; BellSouth comments at 80-81; Ohio Consumers' Counsel comments at 51.

[3178] GTE comments at 82-83; Municipal Utilities comments at 14; USTA comments at 96.

[3179] GTE comments at 82-83; PacTel comments at 101.

[3180] GTE comments at 83.

[3181] *See, e.g.*, Ameritech comments at 98-99; BellSouth comments at 81; Bay Springs *et al* comments at 19; GTE comments at 83; SBC comments at 24; USTA comments at 96-97.

House did not recede to the Senate's language.[3182] GTE urges the Commission to treat the availability of agreements under section 252(i) the same way it treats AT&T Tariff 12 and Contract Tariff offerings.[3183] Ameritech, GTE and SBC also contend that section 252(i)'s requirement that a requesting carrier take service upon the same terms and conditions as the original carrier precludes unbundled availability.[3184] USTA argues unbundled availability of agreement provisions will skew the individualized nature of negotiations, magnify the importance of each individual term of an agreement, and encourage incumbent LECs to offer only standardized, relatively high-cost packages.[3185]

1304. New entrants, joined by the Ohio Commission, support the view that the statute makes individual provisions of agreements available to carriers.[3186] They argue that this comports with the statutory language and legislative history,[3187] and that requiring requesting carriers to take an entire agreement will cause delay[3188] and foster discrimination by enabling incumbent LECs to fashion agreements so that no subsequent carrier may benefit from them.[3189] MCI argues that, although this approach may make incumbents less likely to compromise, the effect on negotiations will be small.[3190] The SBA asserts allowing entrants to utilize individual provisions of agreements will lead to increased competition, which, in turn, will drive prices towards the most economically efficient levels, and that these benefits outweigh any additional burden that

[3182] BellSouth comments at 81.

[3183] GTE comments at 83; *see also* BellSouth comments at 81; USTA comments at 97.

[3184] Ameritech comments at 99; GTE comments at 83; SBC comments at 24.

[3185] USTA comments at 96.

[3186] *See, e.g.*, ALTS comments at 54-55; LDDS comments at 89; Jones Intercable comments at 36; Sprint reply at 48; CompTel reply at 45; AT&T comments at 89-90; NEXTLINK comments at 36-37; MFS comments at 90-91; Time Warner reply at 45-46; Telecommunications Resellers Ass'n comments at 51; Ohio Commission comments at 84. Teleport argues that, if the FCC does not adopt its "preferred outcomes" paradigm for negotiations, it should allow carriers to pick and choose among provisions, asserting that without the ability to pick and choose among provisions, unequal bargaining conditions between LECs and competitive LECs will make meaningful negotiations impossible. Teleport comments at 54-55.

[3187] WinStar comments at 17-18; MCI comments at 96; Jones Intercable comments at 36; SBA comments at 17; Time Warner reply at 46.

[3188] WinStar comments at 18.

[3189] *See, e.g.*, Telecommunications Resellers Ass'n comments at 51; Sprint reply at 48; AT&T comments at 90 n.139; MFS comments at 90-91.

[3190] MCI comments at 96.

such unbundling may place upon incumbents in negotiating agreements.[3191] SBA further argues that failure to permit unbundling of agreements would deter entry by smaller competitors that are unable or unwilling to pay for all of the elements contained in a an agreement negotiated by a larger competitor.[3192] CompTel asks that we rule that an incumbent LEC may not insist upon the observance of any term or condition that is not reasonable in the context of the requesting carrier.[3193]

1305. ALTS suggests that we permit unbundled availability to the level of the individual paragraphs and sections of section 251, with the exception of network elements provided pursuant to section 251(c)(3), which ALTS believes should be provided individually to non-parties on a disaggregated basis.[3194] ALTS argues such a rule would reduce concern that unbundled availability would slow the negotiation process by magnifying the importance of individual terms.[3195] Jones Intercable requests that we clarify that the statute permits so-called "most favored nation" provisions, which allow a new entrant with an interconnection agreement in place with an incumbent LEC to modify such an agreement to substitute the preferable terms included in a later agreement that the incumbent LEC enters with a subsequent new entrant.[3196]

1306. Parties' suggestions for the length of time agreements should remain on file pursuant to section 252(i) range from a reasonable period,[3197] until changes in the network adopted for independent reasons make it no longer feasible to provide interconnection under an agreement,[3198] to as long as the agreement remains in operation.[3199] Out of concern that incumbent LECs might force competitors to renegotiate agreements at unreasonably short

[3191] SBA comments at 18.

[3192] SBA comments at 16-17; *see also* R. Koch comments at 3.

[3193] CompTel comments at 107.

[3194] ALTS comments at 54-55.

[3195] *Id.*

[3196] Jones Intercable comments at 36.

[3197] BellSouth comments at 81-82. GTE suggested agreements remain publicly available for a reasonable period, as Commission requires for AT&T's Tariff 12. GTE comments at 83.

[3198] MCI comments at 97.

[3199] Telecommunications Resellers Ass'n comments at 51-52; Time Warner comments at 114; Lincoln Tel. comments at 25-26.

intervals, the SBA argues that there should be no arbitrary limit on the duration of agreements.[3200]

1307. Several new entrants also raise issues concerning the filing of agreements pursuant to section 252(i). Jones Intercable urges us to require that incumbent LECs file copies of all negotiated agreements at the FCC, as well as at state commissions.[3201]

1308. AT&T and the Telecommunications Resellers Ass'n believe section 252(i) requires that interconnection agreements negotiated prior to enactment of the 1996 Act be available for use by requesting telecommunications carriers,[3202] while F. Williamson opposes this view.[3203] MFS, NCTA and WinStar urge us to find that section 252(i) applies to interconnection agreements between adjacent, non-competing LECs.[3204] BellSouth is opposed.[3205]

3. Discussion

1309. We conclude that it will assist the carriers in determining their respective obligations, facilitate the development of a single, uniform legal interpretation of the Act's requirements and promote a procompetitive, national policy framework to adopt national standards to implement section 252(i). Issues such as whether section 252(i) allows requesting telecommunications carriers to choose among provisions of prior interconnection agreements or requires them to accept an entire agreement are issues of law that should not vary from state to state and are also central to the statutory scheme and to the emergence of competition. National standards will help state commissions and parties to expedite the resolution of disputes under section 252(i).

1310. We conclude that the text of section 252(i) supports requesting carriers' ability to choose among individual provisions contained in publicly filed interconnection agreements. As we note above, section 252(i) provides that a "local exchange carrier shall make available any

[3200] SBA comments at 18.

[3201] Jones Intercable comments at 20.

[3202] AT&T comments at 89; Telecommunications Resellers Ass'n comments at 52.

[3203] F. Williamson comments at 5 (arguing that nothing in the 1996 Act requires that existing agreements be submitted or resubmitted to a state commission for approval). F. Williamson further comments that the statute does not permit one party to an existing agreement compel renegotiation (and/or arbitration) under the procedures in section 252. *Id.*

[3204] MFS comments at 86; NCTA reply at 13; WinStar reply at 19.

[3205] BellSouth comments at 64; *see also* Rural Tel. Coalition comments at 15-16 (asserting sections 251-252 do not apply to agreements between adjacent, non-competing carriers).

interconnection, service, or network element provided under an agreement . . . to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement."[3206] Thus, Congress drew a distinction between "any interconnection, service, or network element[s] provided under an agreement," which the statute lists individually, and agreements in their totality. Requiring requesting carriers to elect entire agreements, instead of the provisions relating to specific elements, would render as mere surplusage the words "any interconnection, service, or network element."

1311. We disagree with BellSouth regarding the significance of the legislative history quoted in the NPRM. The Conference Committee amended section 251(g), S. 652's predecessor to section 252(i), and changed "service, facility, or function" to "interconnection, service, or element." The House of Representatives' bill did not contain a version of section 252(i).[3207] We find that section 252(i)'s language does not differ substantively from the text of the Senate bill's section 251(g). The Senate Commerce Committee stated its provision, section 251(g), was intended to "make interconnection more efficient by making available to other carriers the individual elements of agreements that have been previously negotiated."[3208]

1312. We also find that practical concerns support our interpretation. As observed by AT&T and others, failure to make provisions available on an unbundled basis could encourage an incumbent LEC to insert into its agreement onerous terms for a service or element that the original carrier does not need, in order to discourage subsequent carriers from making a request under that agreement. In addition, we observe that different new entrants face differing technical constraints and costs. Since few new entrants would be willing to elect an entire agreement that would not reflect their costs and the specific technical characteristics of their networks or would not be consistent with their business plans, requiring requesting carriers to elect an entire agreement would appear to eviscerate the obligation Congress imposed in section 252(i).

1313. We also choose this interpretation despite concerns voiced by some incumbent LECs that allowing carriers to choose among provisions will harm the public interest by slowing down the process of reaching interconnection agreements by making incumbent LECs less likely to compromise. In reaching this conclusion, we observe that new entrants, who stand to lose the most if negotiations are delayed, generally do not argue that concern over slow negotiations would outweigh the benefits they would derive from being able to choose among terms of publicly filed agreements. Unbundled access to agreement provisions will enable smaller carriers

[3206] 47 U.S.C. § 252(i).

[3207] Although H.R. 1555's section 244(d) contained similar ideas, its language and structure are sufficiently different from that of section 252(i) that we do not consider section 244(d) to be a prior version of section 252(i).

[3208] *Report of the Committee on Commerce, Science, and Transportation on S. 652*, S. Rpt. 104-23, 104th Cong., 1st Sess. (1995) at 21-22.

who lack bargaining power to obtain favorable terms and conditions -- including rates -- negotiated by large IXCs, and speed the emergence of robust competition.[3209]

1314. We conclude that incumbent LECs must permit third parties to obtain access under section 252(i) to any individual interconnection, service, or network element arrangement on the same terms and conditions as those contained in any agreement approved under section 252. We find that this level of disaggregation is mandated by section 252(a)(1), which requires that agreements shall include "charges for interconnection and each service or network element included in the agreement," and section 251(c)(3), which requires incumbent LECs to provide "non-discriminatory access to network elements on an unbundled basis." In practical terms, this means that a carrier may obtain access to individual elements such as unbundled loops at the same rates, terms, and conditions as contained in any approved agreement. We agree with ALTS that such a view comports with the statute, and lessens the concerns of carriers that argue that unbundled availability will delay negotiations.

1315. We reject GTE's argument that section 252(i)'s statement, that requesting carriers must receive individual elements "upon the same terms and conditions" as those contained in the agreement, precludes unbundled availability of individual elements. GTE's argument fails to give meaning to Congress's distinction between agreements and elements, and ignores the 1996 Act's prime goals of nondiscriminatory treatment of carriers and promotion of competition. Instead, we conclude that the "same terms and conditions" that an incumbent LEC may insist upon shall relate solely to the individual interconnection, service, or element being requested under section 252(i). For instance, where an incumbent LEC and a new entrant have agreed upon a rate contained in a five-year agreement, section 252(i) does not necessarily entitle a third party to receive the same rate for a three-year commitment. Similarly, that one carrier has negotiated a volume discount on loops does not automatically entitle a third party to obtain the same rate for a smaller amount of loops. Given the primary purpose of section 252(i) of preventing discrimination, we require incumbent LECs seeking to require a third party agree to certain terms and conditions to exercise its rights under section 252(i) to prove to the state commission that the terms and conditions were legitimately related to the purchase of the individual element being sought. By contrast, incumbent LECs may not require as a "same" term or condition the new entrant's agreement to terms and conditions relating to other interconnection, services, or elements in the approved agreement. Moreover, incumbent LEC efforts to restrict availability of interconnection, services, or elements under section 252(i) also must comply with the 1996 Act's general nondiscrimination provisions. *See* Section VII.d.3.

1316. We further conclude that section 252(i) entitles all parties with interconnection agreements to "most favored nation" status regardless of whether they include "most favored nation" clauses in their agreements. Congress's command under section 252(i) was that parties may utilize any individual interconnection, service, or element in publicly filed interconnection

[3209] *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 et seq.

agreements and incorporate it into the terms of their interconnection agreement. This means that any requesting carrier may avail itself of more advantageous terms and conditions subsequently negotiated by any other carrier for the same individual interconnection, service, or element once the subsequent agreement is filed with, and approved by, the state commission. We believe the approach we adopt will maximize competition by ensuring that carriers' obtain access to terms and elements on a nondiscriminatory basis.

1317. We find that section 252(i) permits differential treatment based on the LEC's cost of serving a carrier. We further observe that section 252(d)(1) requires that unbundled element rates be cost-based, and sections 251(c)(2) and (c)(3) require incumbent LECs to provide only technically-feasible forms of interconnection and access to unbundled elements, while section 252(i) mandates that the availability of publicly-filed agreements be limited to carriers willing to accept the same terms and conditions as the carrier who negotiated the original agreement with the incumbent LEC. We conclude that these provisions, read together, require that publicly-filed agreements be made available only to carriers who cause the incumbent LEC to incur no greater costs than the carrier who originally negotiated the agreement, so as to result in an interconnection arrangement that is both cost-based and technically feasible. However, as discussed in Section VII regarding discrimination, where an incumbent LEC proposes to treat one carrier differently than another, the incumbent LEC must prove to the state commission that that differential treatment is justified based on the cost to the LEC of providing that element to the carrier.

1318. We conclude, however, that section 252(i) does not permit LECs to limit the availability of any individual interconnection, service, or network element only to those requesting carriers serving a comparable class of subscribers or providing the same service (*i.e.*, local, access, or interexchange) as the original party to the agreement. In our view, the class of customers, or the type of service provided by a carrier, does not necessarily bear a direct relationship with the costs incurred by the LEC to interconnect with that carrier or on whether interconnection is technically feasible. Accordingly, we conclude that an interpretation of section 252(i) that attempts to limit availability by class of customer served or type of service provided would be at odds with the language and structure of the statute, which contains no such limitation.

1319. We agree with those commenters who suggest that agreements remain available for use by requesting carriers for a reasonable amount of time. Such a rule addresses incumbent LEC concerns over technical incompatibility, while at the same time providing requesting carriers with a reasonable time during which they may benefit from previously negotiated agreements. In addition, this approach makes economic sense, since the pricing and network configuration choices are likely to change over time, as several commenters have observed. Given this reality, it would not make sense to permit a subsequent carrier to impose an agreement or term upon an incumbent LEC if the technical requirements of implementing that agreement or term have changed.

1320. We observe that section 252(h) expressly provides that state commissions maintain for public inspection copies of interconnection agreements approved under section 252(e). We therefore decline Jones Intercable's suggestion that we require carriers to file agreements at the FCC, in addition to section 252(h)'s filing requirement. However, when the Commission performs the state's responsibilities under section 252(e)(5), parties must file their agreements with the Commission, as well as with the state commission.[3210]

1321. We further conclude that a carrier seeking interconnection, network elements, or services pursuant to section 252(i) need not make such requests pursuant to the procedures for initial section 251 requests, but shall be permitted to obtain its statutory rights on an expedited basis. We find that this interpretation furthers Congress's stated goals of opening up local markets to competition and permitting interconnection on just, reasonable, and nondiscriminatory terms, and that we should adopt measures that ensure competition occurs as quickly and efficiently as possible. We conclude that the nondiscriminatory, pro-competition purpose of section 252(i) would be defeated were requesting carriers required to undergo a lengthy negotiation and approval process pursuant to section 251 before being able to utilize the terms of a previously approved agreement. Since agreements shall necessarily be filed with the states pursuant to section 252(h), we leave to state commissions in the first instance the details of the procedures for making agreements available to requesting carriers on an expedited basis. Because of the importance of section 252(i) in preventing discrimination, however, we conclude that carriers seeking remedies for alleged violations of section 252(i) shall be permitted to obtain expedited relief at the Commission, including the resolution of complaints under section 208 of the Communications Act, in addition to their state remedies.

1322. We conclude as well that agreements negotiated prior to enactment of the 1996 Act must be available for use by subsequent, requesting carriers. Section 252(i) must be read in conjunction with section 252(a)(1), which clearly states that "agreement" for purposes of section 252, "includ[es] any interconnection agreement negotiated before the date of enactment . . . ."[3211] We conclude that this language demonstrates that Congress intended 252(i) to apply to agreements negotiated prior to enactment of the 1996 Act and approved by the state commission pursuant to section 252(e), as well as those approved under the section 251/252 negotiation process. Accordingly, we find that agreements negotiated prior to enactment of the 1996 Act must be disclosed publicly, and be made available to requesting telecommunications carriers pursuant to section 252(i).

1323. We also find that section 252(i) applies to interconnection agreements between adjacent, incumbent LECs. We note that section 252(i) requires a local exchange carrier to make

[3210] We note section 22.903(d) of our rules, which remains in effect, requires the BOCs to file with us their interconnection agreements with their affiliated cellular providers. 47 C.F.R. § 22.903(d).

[3211] 47 U.S.C. § 252(a)(1).

available to requesting telecommunications carriers "any interconnection service, or network element *provided under an agreement approved under this section* . . . ."[3212] The plain meaning of this section is that any interconnection agreement approved by a state commission, including one between adjacent LECs, must be made available to requesting carriers pursuant to section 252(i). Requiring availability of such agreements will provide new entrants with a realistic benchmark upon which to base negotiations, and this will further the Congressional purpose of increasing competition. As stated in Section III of this Order, adjacent, incumbent LECs will be given an opportunity to renegotiate such agreements before they become subject to section 252(i)'s requirements. In Section III, we also consider, and reject, the Rural Tel. Coalition's argument that making agreements between adjacent, non-competing LECs available under section 252 will have a detrimental effect on small, rural carriers. *See* Section III, *supra*.

[3212] 47 U.S.C. § 252(i) (emphasis supplied).

XV. FINAL REGULATORY FLEXIBILITY ANALYSIS

1324. As required by Section 603 of the Regulatory Flexibility Act (RFA), 5 U.S.C. § 603, an Initial Regulatory Flexibility Analysis (IRFA) was incorporated in the NPRM. The Commission sought written public comment on the proposals in the NPRM. The Commission's Final Regulatory Flexibility Analysis (FRFA) in this Order conforms to the RFA, as amended by the Contract With America Advancement Act of 1996 (CWAAA), Pub. L. No. 104-121, 110 Stat. 847 (1996).[3213]

A. Need for and Objectives of this Report and Order and the Rules Adopted Herein

1325. The Commission, in compliance with section 251(d)(1) of the Communications Act of 1934, as amended by the Telecommunications Act of 1996 (the 1996 Act), promulgates the rules in this Order to ensure the prompt implementation of sections 251 and 252 of the 1996 Act, which are the local competition provisions. Congress sought to establish through the 1996 Act "a pro-competitive, de-regulatory national policy framework" for the United States telecommunications industry.[3214] Three principal goals of the telephony provisions of the 1996 Act are: (1) opening local exchange and exchange access markets to competition; (2) promoting increased competition in telecommunications markets that are already open to competition, particularly long distance services markets; and, (3) reforming our system of universal service so that universal service is preserved and advanced as local exchange and exchange access markets move from monopoly to competition.

1326. The rules adopted in this Order implement the first of these goals -- opening local exchange and exchange access markets to competition. The objective of the rules adopted in this Order is to implement as quickly and effectively as possible the national telecommunications policies embodied in the 1996 Act and to promote the development of competitive, deregulated markets envisioned by Congress.[3215] In doing so, we are mindful of the balance that Congress struck between this goal of bringing the benefits of competition to all consumers and its concern for the impact of the 1996 Act on small incumbent local exchange carriers, particularly rural carriers, as evidenced in section 251(f) of the 1996 Act.

[3213] Subtitle II of the CWAAA is "The Small Business Regulatory Enforcement Fairness Act of 1996" (SBREFA), codified at 5 U.S.C. § 601 *et seq.*

[3214] S. Conf. Rep. No. 230, 104th Cong., 2d Sess. 1 (1996).

[3215] *Id.*

B. Analysis of Significant Issues Raised in Response to the IRFA

1327. *Summary of the Initial Regulatory Flexibility Analysis (IRFA).* In the NPRM, the Commission performed an IRFA.[3216] In the IRFA, the Commission found that the rules it proposed to adopt in this proceeding may have a significant impact on a substantial number of small business as defined by section 601(3) of the RFA. The Commission stated that its regulatory flexibility analysis was inapplicable to incumbent LECs because such entities are dominant in their field of operation. The Commission noted, however, that it would take appropriate steps to ensure that the special circumstances of smaller incumbent LECs are carefully considered in our rulemaking. The Commission also found that the proposed rules may overlap or conflict with the Commission's Part 69 access charge and *Expanded Interconnection* rules. Finally, the IRFA solicited comment on alternatives to our proposed rules that would minimize the impact on small entities consistent with the objectives of this proceeding.

1. Treatment of Small LECs

1328. *Comments.* The Small Business Administration (SBA), the Rural Telephone Coalition (Rural Tel. Coalition), and CompTel maintain that the Commission violated the RFA when it failed to include small incumbent LECs in its IRFA without first consulting SBA to establish a definition of "small business."[3217] Rural Tel. Coalition and CompTel also argue that the Commission failed to explain its statement that "incumbent LECs are dominant in their field of operation" or how that finding was reached.[3218] Rural Tel. Coalition states that such an analysis of the market power of incumbent LECs is necessary because incumbent LECs are now facing competition from a variety of sources, including wireline and wireless carriers. Rural Tel. Coalition recommends that the Commission abandon its determination that all incumbent LECs are dominant, and perform regulatory flexibility analysis for incumbent LECs having fewer than 1500 employees.[3219]

1329. *Discussion.* In essence, SBA and Rural Tel. Coalition argue that we exceeded our authority under the RFA by certifying all incumbent LECs as dominant in their field of operation, and concluding on that basis that they are not small businesses under the RFA. SBA and Rural Tel. Coalition contend that the authority to make a size determination rests solely with SBA and that, by excluding a group (small incumbent LECs) from coverage under the RFA, the

[3216] NPRM at paras. 274-287.

[3217] SBA RFA comments at 3-5; Rural Tel. Coalition reply at 38-39; CompTel reply at 46.

[3218] Rural Tel. Coalition reply at 39; CompTel reply at 46.

[3219] Rural Tel. Coalition reply at 40.

Commission made an unauthorized size determination.[3220] Neither SBA nor Rural Tel. Coalition cites any specific authority for this latter proposition.

1330. We have found incumbent LECs to be "dominant in their field of operation" since the early 1980's, and we consistently have certified under the RFA[3221] that incumbent LECs are not subject to regulatory flexibility analyses because they are not small businesses.[3222] We have made similar determinations in other areas.[3223] We recognize SBA's special role and expertise with regard to the RFA, and intend to continue to consult with SBA outside the context of this proceeding to ensure that the Commission is fully implementing the RFA. Although we are not fully persuaded on the basis of this record that our prior practice has been incorrect, in light of the special concerns raised by SBA and Rural Tel. Coalition in this proceeding, we will, nevertheless, include small incumbent LECs in this FRFA to remove any possible issue of RFA compliance. We, therefore, need not address Rural Tel. Coalition's arguments that incumbent LECs are not dominant.[3224]

2. Other Issues

1331. *Comments.* Parties raised several other issues in response to the Commission's IRFA in the NPRM. SBA and CompTel contend that commenters should not be required to separate their comments on the IRFA from their comments on the other issues raised in the NPRM.[3225] SBA maintains that separating RFA comments and discussion from the rest of the comments "isolates" the regulatory flexibility analysis from the remainder of the discussion, thereby handicapping the Commission's analysis of the impact of the proposed rules on small businesses.[3226] SBA further suggests that our IRFA failed to: (1) give an adequate description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rules,

[3220] SBA RFA comments at 4-5 (citing 15 U.S.C. §632(a)(2)); Rural Tel. Coalition reply at 38.

[3221] *See* 5 U.S.C. § 605(b).

[3222] *See, e.g., Expanded Interconnection with Local Telephone Company Facilities*, Supplemental Notice of Proposed Rulemaking, 6 FCC Rcd 5809 (1991); *MTS and WATS Market Structure*, Report and Order, 2 FCC Rcd 2953, 2959 (1987) (citing *MTS and WATS Market Structure*, Third Report and Order, 93 F.C.C.2d 241, 338-39 (1983)).

[3223] *See, e.g., In the Matter of Implementation of Sections of the Cable Television Consumer Protection Act of 1992: Rate Regulation*, Sixth Report and Order and Eleventh Order on Reconsideration, 10 FCC Rcd 7393, 7418 (1995).

[3224] Rural Tel. Coalition reply at 39-40.

[3225] SBA RFA comments at 2-3, CompTel reply at 46.

[3226] *Id.*

including an estimate of the classes of small entities that will be subject to the requirement and the professional skills necessary to prepare such reports or records;[3227] and (2) describe significant alternatives that minimize the significant economic impact of the proposal on small entities, including exemption from coverage of the rule.[3228] SBA also asserts that none of the alternatives in the NPRM is designed to minimize the impact of the proposed rules on small businesses.

1332. The Idaho Commission argues that the Commission's rules will be devised for large carriers and therefore will be "de facto burdensome" to Idaho's incumbent LECs and probably to potential new entrants, which may be small companies.[3229] Therefore, Idaho requests that state commissions be permitted flexibility to address the impacts of our rules on smaller incumbent LECs.

1333. The Small Cable Business Association (SCBA) contends that the Commission's IRFA is inadequate because it does not state that small cable companies are among the small entities affected by the proposed rules.[3230] In its comments on the IRFA, SCBA refers to its proposal that the Commission establish the following national standards for small cable companies: (1) the definition of "good faith" negotiation; (2) the development of less burdensome arbitration procedures for interconnection and resale; (3) the designation of a small company contact person at incumbent LECs and state commissions; and (4) the application of section 251(f) of the 1996 Act.[3231]

1334. *Discussion.* We disagree with SBA's assessment of our IRFA. Although the IRFA referred only generally to the reporting and recordkeeping requirements imposed on incumbent LECs, our Federal Register notice set forth in detail the general reporting and recordkeeping requirements as part of our Paperwork Reduction Act statement.[3232] The IRFA also sought comment on the many alternatives discussed in the body of the NPRM, including the statutory exemption for certain rural telephone companies.[3233] The numerous general public comments concerning the impact of our proposal on small entities in response to the NPRM, including

[3227] SBA RFA comments at 5-6, *citing* 5 U.S.C. § 603(b)(4).

[3228] SBA RFA comments at 7-8, *citing* 5 U.S.C. § 603(c).

[3229] Idaho Commission comments at 15.

[3230] SCBA RFA comments at 1.

[3231] *Id.* at 1-2.

[3232] NPRM, at para. 283 (rel. Apr. 19, 1996), *summarized at* 61 Fed. Reg. 18311, 18312 (Apr. 25, 1996).

[3233] 47 U.S.C. § 251(f).

comments filed directly in response to the IRFA,[3234] enabled us to prepare this FRFA. Thus, we conclude that the IRFA was sufficiently detailed to enable parties to comment meaningfully on the proposed rules and, thus, for us to prepare this FRFA. We have been working with, and will continue to work with SBA, to ensure that both our IRFAs and FRFAs fully meet the requirements of the RFA.

1335. SBA also objects to the NPRM's requirement that responses to the IRFA be filed under a separate and distinct heading, and proposes that we integrate RFA comments into the body of general comments on a rule.[3235] Almost since the adoption of the RFA, we have requested that IRFA comments be submitted under a separate and distinct heading.[3236] Neither the RFA nor SBA's rules prescribe the manner in which comments may be submitted in response to an IRFA[3237] and, in such circumstances, it is well established that an administrative agency can structure its proceedings in any manner that it concludes will enable it to fulfill its statutory duties.[3238] Based on our past practice, we find that separation of comments responsive to the IRFA facilitates our preparation of a compulsory summary of such comments and our responses to them, as required by the RFA. Comments on the impact of our proposed rules on small entities have been integrated into our analysis and consideration of the final rules. We, therefore, reject SBA's argument that we improperly required commenters to include their comments on the IRFA in a separate section.

1336. We also reject SBA's assertion that none of the alternatives in the NPRM is designed to minimize the impact of the proposed rules on small businesses. For example, we proposed that incumbent LECs be required to offer competitors access to unbundled local loop, switching, and transport facilities.[3239] These proposals permit potential competitors to enter the market by relying, in part or entirely, on the incumbent LEC's facilities. Reduced economic entry barriers are designed to provide reasonable opportunities for new entrants, particularly small entities, to enter the market by minimizing the initial investment needed to begin providing service. In addition, we believe section 251(f) and our rules provide states with significant

[3234] SBA RFA comments; Rural Tel. Coalition reply at 38-41; Idaho Commission comments at 15; SCBA RFA comments; CompTel reply at 45-46.

[3235] SBA RFA comments at 2.

[3236] *See, e.g., Inquiry into the Development of Regulatory Policy in Regard to Direct Broadcast Satellites*, Notice of Proposed Policy Statement and Rulemaking, 86 F.C.C.2d 719, 755 (1981).

[3237] *See* 5 U.S.C. § 603 (IRFA requirements).

[3238] *See Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519, 524-25 (1978), *citing FCC v. Schreiber*, 381 U.S. 279, 290 (1965) and *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134, 138 (1940).

[3239] NPRM paras. 94-97.

flexibility to "deal with the needs of individual companies in light of public interest concerns," as requested by the Idaho Commission. With regard to the potential burdens on small entities other than incumbent LECs, we believe our rules permit states to structure arbitration procedures, for example, in ways that minimize filing or other burdens on new entrants that are small entities.

1337. We also disagree with SCBA's assertion that the IRFA was deficient because it did not identify small cable operators as entities that would be affected by the proposed rules. The IRFA in the NPRM states: "Insofar as the proposals in this Notice apply to telecommunications carriers other than incumbent LECs (generally interexchange carriers and new LEC entrants), they may have a significant impact on a substantial number of small entities."[3240] The phrase "new LEC entrants" clearly encompasses small cable operators that become providers of local exchange service. The NPRM even identifies cable operators as potential new entrants.[3241]

1338. We agree with SCBA's argument that the Commission should identify certain minimum standards to provide guidance on the requirement that parties negotiate in good faith.[3242] As discussed in Section III.B, we conclude that we should establish minimum standards that will offer parties guidance in determining whether they are acting in good faith. We believe that these minimum standards address SCBA's assertion that federal guidelines for good faith negotiations may be particularly important for small entities because unreasonable delays in negotiations could represent an entry barrier for small entities.

1339. We also agree with SCBA's recommendation that we should establish guidelines for the application of section 251(f) regarding exemptions, suspensions, and modifications of our rules governing interconnection with rural carriers. As discussed in section XII.B, we find that a rural incumbent LEC should not be able to obtain an exemption, suspension, or modification of its obligations under section 251 unless it offers evidence that the application of those requirements would be likely to cause injury beyond the financial harm typically associated with efficient competitive entry. We are also persuaded by the suggestion of SCBA and others that incumbent LECs should bear the burden of showing that they should be exempt pursuant to section 251(f)(1) from national interconnection requirements. We believe that this finding is consistent with the pro-competitive goals of the 1996 Act and our determination in Section XII that Congress did not intend to withhold from consumers the benefits of local telephone competition that could be provided by small entities, such as small cable operators.

[3240] NPRM para. 277.

[3241] NPRM para. 7.

[3242] This good faith requirement is found in 47 U.S.C. § 251(c)(1).

1340. We do not adopt SCBA's proposal to establish abbreviated arbitration procedures.[3243] Most commenters oppose adoption of federal rules to govern state mediation and arbitration proceedings. As set out in Section XIV.A, we conclude that state commissions are better positioned to develop rules for mediation and arbitration that support the objectives of the 1996 Act. The rules we adopt in Section XIV.A apply only where the Commission assumes a state commission's responsibilities pursuant to section 252(e)(5). States may develop specific measures that address the concerns of small entities participating in mediation or arbitration, as suggested by SCBA. In addition, although we do not specifically incorporate SCBA's request that the Commission designate a "small company contact person at incumbent LECs and state commissions,"[3244] we find that a refusal throughout the negotiation process to designate a representative with authority to make binding representations on behalf of the party, and thereby significantly delay resolution of issues, would constitute failure to negotiate in good faith. Therefore, we conclude that the potential benefits of SCBA's proposal are achieved by our determination that the failure of an incumbent LEC to designate a person authorized to bind his or her company in negotiations is a violation of the good faith obligation of section 251.

C. Description and Estimates of the Number of Small Entities Affected by this Report and Order

1341. For the purposes of this Order, the RFA defines a "small business" to be the same as a "small business concern" under the Small Business Act, 15 U.S.C. § 632, unless the Commission has developed one or more definitions that are appropriate to its activities.[3245] Under the Small Business Act, a "small business concern" is one that: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) meets any additional criteria established by the Small Business Administration (SBA).[3246] SBA has defined businesses in Standard Industrial Classification (SIC) categories 4812 (Radiotelephone Communications) and 4813 (Telephone Communications, Except Radiotelephone) to be small entities when they have fewer than 1,500 employees.[3247] We first discuss generally the total number of small telephone companies falling within both of those SIC categories. Then, we discuss the number of small businesses within the two subcategories, and attempt to refine further those estimates to correspond with the categories of telephone companies that are commonly used under our rules.

[3243] SCBA RFA comments at 1-2.

[3244] SCBA RFA comments at 2.

[3245] *See* 15 U.S.C. § 601(3) (incorporating by reference the definition of "small business concern" in 5 U.S.C. § 632).

[3246] 15 U.S.C. § 632. *See, e.g., Brown Transport Truckload, Inc. v. Southern Wipers, Inc.*, 176 B.R. 82 (N.D. Ga. 1994).

[3247] 13 C.F.R. § 121.201.

1342. Consistent with our prior practice, we shall continue to exclude small incumbent LECs from the definition of a small entity for the purpose of this FRFA. Nevertheless, as mentioned above, we include small incumbent LECs in our FRFA. Accordingly, our use of the terms "small entities" and "small businesses" does not encompass "small incumbent LECs." We use the term "small incumbent LECs" to refer to any incumbent LECs that arguably might be defined by SBA as "small business concerns."[3248]

1. Telephone Companies (SIC 481)

1343. *Total Number of Telephone Companies Affected.* Many of the decisions and rules adopted herein may have a significant effect on a substantial number of the small telephone companies identified by SBA. The United States Bureau of the Census ("the Census Bureau") reports that, at the end of 1992, there were 3,497 firms engaged in providing telephone services, as defined therein, for at least one year.[3249] This number contains a variety of different categories of carriers, including local exchange carriers, interexchange carriers, competitive access providers, cellular carriers, mobile service carriers, operator service providers, pay telephone operators, PCS providers, covered SMR providers, and resellers. It seems certain that some of those 3,497 telephone service firms may not qualify as small entities or small incumbent LECs because they are not "independently owned and operated."[3250] For example, a PCS provider that is affiliated with an interexchange carrier having more than 1,500 employees would not meet the definition of a small business. It seems reasonable to conclude, therefore, that fewer than 3,497 telephone service firms are small entity telephone service firms or small incumbent LECs that may be affected by this Order.

1344. *Wireline Carriers and Service Providers.* SBA has developed a definition of small entities for telephone communications companies other than radiotelephone (wireless) companies. The Census Bureau reports that, there were 2,321 such telephone companies in operation for at least one year at the end of 1992.[3251] According to SBA's definition, a small business telephone company other than a radiotelephone company is one employing fewer than 1,500 persons.[3252] All but 26 of the 2,321 non-radiotelephone companies listed by the Census Bureau were reported to have fewer than 1,000 employees. Thus, even if all 26 of those companies had more than 1,500 employees, there would still be 2,295 non-radiotelephone companies that might qualify as

[3248] *Id.*

[3249] United States Department of Commerce, Bureau of the Census, *1992 Census of Transportation, Communications, and Utilities: Establishment and Firm Size*, at Firm Size 1-123 (1995) (*1992 Census*).

[3250] 15 U.S.C. § 632(a)(1).

[3251] *1992 Census, supra*, at Firm Size 1-123.

[3252] 13 C.F.R. § 121.201, Standard Industrial Classification (SIC) Code 4812.

small entities or small incumbent LECs. Although it seems certain that some of these carriers are not independently owned and operated, we are unable at this time to estimate with greater precision the number of wireline carriers and service providers that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 2,295 small entity telephone communications companies other than radiotelephone companies that may be affected by the decisions and rules adopted in this Order.

1345. *Local Exchange Carriers.* Neither the Commission nor SBA has developed a definition of small providers of local exchange services (LECs). The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of LECs nationwide of which we are aware appears to be the data that we collect annually in connection with the Telecommunications Relay Service (TRS). According to our most recent data, 1,347 companies reported that they were engaged in the provision of local exchange services.[3253] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of LECs that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 1,347 small incumbent LECs that may be affected by the decisions and rules adopted in this Order.

1346. *Interexchange Carriers.* Neither the Commission nor SBA has developed a definition of small entities specifically applicable to providers of interexchange services (IXCs). The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of IXCs nationwide of which we are aware appears to be the data that we collect annually in connection with TRS. According to our most recent data, 97 companies reported that they were engaged in the provision of interexchange services.[3254] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of IXCs that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 97 small entity IXCs that may be affected by the decisions and rules adopted in this Order.

1347. *Competitive Access Providers.* Neither the Commission nor SBA has developed a definition of small entities specifically applicable to providers of competitive access services (CAPs). The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of CAPs nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 30 companies reported that they were engaged in the provision of competitive access services.[3255] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of CAPs that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 30 small entity CAPs that may be affected by the decisions and rules adopted in this Order.

1348. *Operator Service Providers.* Neither the Commission nor SBA has developed a definition of small entities specifically applicable to providers of operator services. The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of operator service providers nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 29 companies reported that they were engaged in the provision of operator services.[3256] Although it seems certain that some of these companies are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of operator service providers that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 29 small entity operator service providers that may be affected by the decisions and rules adopted in this Order.

1349. *Pay Telephone Operators.* Neither the Commission nor SBA has developed a definition of small entities specifically applicable to pay telephone operators. The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of pay telephone operators nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 197 companies reported that they were engaged in the provision of pay telephone services.[3257] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of pay telephone operators that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 197 small entity pay telephone operators that may be affected by the decisions and rules adopted in this Order.

[3253] Federal Communications Commission, CCB, Industry Analysis Division, *Telecommunications Industry Revenue: TRS Fund Worksheet Data*, Tbl. 21 (Average Total Telecommunications Revenue Reported by Class of Carrier) (Feb. 1996) (*TRS Worksheet*).

[3254] *Id.*

[3255] *Id.*

[3256] *Id.*

[3257] *Id.*

1350. *Wireless (Radiotelephone) Carriers*. SBA has developed a definition of small entities for radiotelephone (wireless) companies. The Census Bureau reports that there were 1,176 such companies in operation for at least one year at the end of 1992.[3258] According to SBA's definition, a small business radiotelephone company is one employing fewer than 1,500 persons.[3259] The Census Bureau also reported that 1,164 of those radiotelephone companies had fewer than 1,000 employees. Thus, even if all of the remaining 12 companies had more than 1,500 employees, there would still be 1,164 radiotelephone companies that might qualify as small entities if they are independently owned are operated. Although it seems certain that some of these carriers are not independently owned and operated, we are unable at this time to estimate with greater precision the number of radiotelephone carriers and service providers that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 1,164 small entity radiotelephone companies that may be affected by the decisions and rules adopted in this Order.

1351. *Cellular Service Carriers*. Neither the Commission nor SBA has developed a definition of small entities specifically applicable to providers of cellular services. The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of cellular service carriers nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 789 companies reported that they were engaged in the provision of cellular services.[3260] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of cellular service carriers that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 789 small entity cellular service carriers that may be affected by the decisions and rules adopted in this Order.

1352. *Mobile Service Carriers*. Neither the Commission nor SBA has developed a definition of small entities specifically applicable to mobile service carriers, such as paging companies. The closest applicable definition under SBA rules is for telephone communications companies other than radiotelephone (wireless) companies. The most reliable source of information regarding the number of mobile service carriers nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 117 companies reported that they were engaged in the provision of mobile

[3258] United States Department of Commerce, Bureau of the Census, *1992 Census of Transportation, Communications, and Utilities: Establishment and Firm Size*, at Firm Size 1-123 (1995) (*1992 Census*).

[3259] 13 C.F.R. § 121.201, Standard Industrial Classification (SIC) Code 4812.

[3260] *Id.*

services.[3261] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500 employees, we are unable at this time to estimate with greater precision the number of mobile service carriers that would qualify under SBA's definition. Consequently, we estimate that there are fewer than 117 small entity mobile service carriers that may be affected by the decisions and rules adopted in this Order.

1353. *Broadband PCS Licensees*. The broadband PCS spectrum is divided into six frequency blocks designated A through F. As set forth in 47 C.F.R. § 24.720(b), the Commission has defined "small entity" in the auctions for Blocks C and F as a firm that had average gross revenues of less than $40 million in the three previous calendar years. Our definition of a "small entity" in the context of broadband PCS auctions has been approved by SBA.[3262] The Commission has auctioned broadband PCS licenses in Blocks A, B, and C. We do not have sufficient data to determine how many small businesses bid successfully for licenses in Blocks A and B. There were 90 winning bidders that qualified as small entities in the Block C auction. Based on this information, we conclude that the number of broadband PCS licensees affected by the decisions in this Order includes, at a minimum, the 90 winning bidders that qualified as small entities in the Block C broadband PCS auction.

1354. At present, no licenses have been awarded for Blocks D, E, and F of broadband PCS spectrum. Therefore, there are no small businesses currently providing these services. However, a total of 1,479 licenses will be awarded in the D, E, and F Block broadband PCS auctions, which are scheduled to begin on August 26, 1996. Eligibility for the 493 F Block licenses is limited to entrepreneurs with average gross revenues of less than $125 million.[3263] We cannot estimate, however, the number of these licenses that will be won by small entities under our definition, nor how many small entities will win D or E Block licenses. Given that nearly all radiotelephone companies have fewer than 1,000 employees[3264] and that no reliable estimate of the number of prospective D, E, and F Block licensees can be made, we assume for purposes of this FRFA, that all of the licenses in the D, E, and F Block Broadband PCS auctions may be awarded to small entities under our rules, which may be affected by the decisions and rules adopted in this Order.

[3261] *Id.*

[3262] *See Implementation of Section 309(j) of the Communications Act -- Competitive Bidding*, PP Docket No. 93-253, Fifth Report and Order, 9 FCC Rcd 5532, 5581-84 (1994).

[3263] *Amendment of Parts 20 and 24 of the Commission's Rules -- Broadband PCS Competitive Bidding and the Commercial Mobile Radio Service Spectrum Cap*, WT Docket No. 96-59, *Amendment of the Commission's Cellular/PCS Cross-Ownership Rule*, Report and Order, GN Docket No. 90-314, FCC 96-278 (rel. June 24, 1996).

[3264] *1992 Census*, Table 5, Employment Size of Firms: 1992, SIC Code 4812.

1355. *SMR Licensees.* Pursuant to 47 C.F.R. § 90.814(b)(1), the Commission has defined "small entity" in auctions for geographic area 800 MHz and 900 MHz SMR licenses as a firm that had average annual gross revenues of less than $15 million in the three previous calendar years. This definition of a "small entity" in the context of 800 MHz and 900 MHz SMR has been approved by the SBA.[3265] The rules adopted in this Order may apply to SMR providers in the 800 MHz and 900 MHz bands that either hold geographic area licenses or have obtained extended implementation authorizations. We do not know how many firms provide 800 MHz or 900 MHz geographic area SMR service pursuant to extended implementation authorizations, nor how many of these providers have annual revenues of less than $15 million. We assume, for purposes of this FRFA, that all of the extended implementation authorizations may be held by small entities, which may be affected by the decisions and rules adopted in this Order.

1356. The Commission recently held auctions for geographic area licenses in the 900 MHz SMR band. There were 60 winning bidders who qualified as small entities in the 900 MHz auction. Based on this information, we conclude that the number of geographic area SMR licensees affected by the rules adopted in this Order includes these 60 small entities. No auctions have been held for 800 MHz geographic area SMR licenses. Therefore, no small entities currently hold these licenses. A total of 525 licenses will be awarded for the upper 200 channels in the 800 MHz geographic area SMR auction. However, the Commission has not yet determined how many licenses will be awarded for the lower 230 channels in the 800 MHz geographic area SMR auction. There is no basis, moreover, on which to estimate how many small entities will win these licenses. Given that nearly all radiotelephone companies have fewer than 1,000 employees and that no reliable estimate of the number of prospective 800 MHz licensees can be made, we assume, for purposes of this FRFA, that all of the licenses may be awarded to small entities who, thus, may be affected by the decisions in this Order.

1357. *Resellers.* Neither the Commission nor SBA has developed a definition of small entities specifically applicable to resellers. The closest applicable definition under SBA rules is for all telephone communications companies. The most reliable source of information regarding the number of resellers nationwide of which we are aware appears to be the data that we collect annually in connection with the TRS. According to our most recent data, 206 companies reported that they were engaged in the resale of telephone services.[3266] Although it seems certain that some of these carriers are not independently owned and operated, or have more than 1,500

[3265] *See Amendment of Parts 2 and 90 of the Commission's Rules to Provide for the Use of 200 Channels Outside the Designated Filing Areas in the 896-901 MHz and the 935-940 MHz Bands Allotted to the Specialized Mobile Radio Pool*, PR Docket No. 89-583, Second Order on Reconsideration and Seventh Report and Order, 11 FCC Rcd 2639, 2693-702 (1995); *Amendment of Part 90 of the Commission's Rules to Facilitate Future Development of SMR Systems in the 800 MHz Frequency Band*, PR Docket No. 93-144, First Report and Order, Eighth Report and Order, and Second Further Notice of Proposed Rulemaking, 11 FCC Rcd 1463 (1995).

[3266] *TRS Worksheet, supra.*

employees, we are unable at this time to estimate with greater precision the number of resellers that would qualify as small business concerns under SBA's definition. Consequently, we estimate that there are fewer than 206 small entity resellers that may be affected by the decisions and rules adopted in this Order.

2. Cable System Operators (SIC 4841)

1358. SBA has developed a definition of small entities for cable and other pay television services, which includes all such companies generating less than $11 million in revenue annually. This definition includes cable systems operators, closed circuit television services, direct broadcast satellite services, multipoint distribution systems, satellite master antenna systems and subscription television services. According to the Census Bureau, there were 1,323 such cable and other pay television services generating less than $10 million in revenue that were in operation for at least one year at the end of 1992.[3267]

1359. The Commission has developed its own definition of a small cable system operator for the purposes of rate regulation. Under the Commission's rules, a "small cable company," is one serving fewer than 400,000 subscribers nationwide.[3268] Based on our most recent information, we estimate that there were 1,439 cable operators that qualified as small cable system operators at the end of 1995.[3269] Since then, some of those companies may have grown to serve over 400,000 subscribers, and others may have been involved in transactions that caused them to be combined with other cable operators. Consequently, we estimate that there are fewer than 1,468 small entity cable system operators that may be affected by the decisions and rules adopted in this Order.

1360. The Communications Act also contains a definition of a small cable system operator, which is "a cable operator that, directly or through an affiliate, serves in the aggregate fewer than 1 percent of all subscribers in the United States and is not affiliated with any entity or entities whose gross annual revenues in the aggregate exceed $250,000,000."[3270] There were 63,196,310 basic cable subscribers at the end of 1995, and 1,450 cable system operators serving fewer than one percent (6[illegible],960) of subscribers.[3271] Although it seems certain that some of these

[3267] *1992 Census, supra,* Table 4 (Revenue Size of Firms: 1992), SIC 4841.

[3268] 47 C.F.R. § 76.901(e). The Commission developed this definition based on its determination that a small cable system operator is one with annual revenues of $100 million or less. *Implementation of Sections of the 1992 Cable Act: Rate Regulation*, Sixth Report and Order and Eleventh Order on Reconsideration, 10 FCC Rcd 7393.

[3269] Paul Kagan Associates, Inc., *Cable TV Investor*, Feb. 29, 1996 (based on figures for Dec. 30, 1995).

[3270] 47 U.S.C. § 543(m)(2).

[3271] Paul Kagan Associates, Inc., *Cable TV Investor*, Feb. 29, 1996 (based on figures for Dec. 30, 1995).

cable system operators are affiliated with entities whose gross annual revenues exceed $250,000,000, we are unable at this time to estimate with greater precision the number of cable system operators that would qualify as small cable operators under the definition in the Communications Act.

D. Summary Analysis of the Projected Reporting, Recordkeeping, and Other Compliance Requirements and Steps Taken to Minimize the Significant Economic Impact of this Report and Order on Small Entities and Small Incumbent LECs, Including the Significant Alternatives Considered and Rejected

1361. *Structure of the Analysis.* In this section of the FRFA, we analyze the projected reporting, recordkeeping, and other compliance requirements that may apply to small entities and small incumbent LECs as a result of this Order.[3272] As a part of this discussion, we mention some of the types of skills that will be needed to meet the new requirements. We also describe the steps taken to minimize the economic impact of our decisions on small entities and small incumbent LECs, including the significant alternatives considered and rejected.[3273] Due to the size of this Order, we set forth our analysis separately for individual sections of the item, using the same headings as were used above in the corresponding sections of the Order.

1362. We provide this summary analysis to provide context for our analysis in this FRFA. To the extent that any statement contained in this FRFA is perceived as creating ambiguity with respect to our rules or statements made in preceding sections of this Order, the rules and statements set forth in those preceding sections shall be controlling.

Summary Analysis of Section II
SCOPE OF THE COMMISSION'S RULES

1363. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* As discussed in Section II.E, a common carrier, which may be a small entity or a small incumbent LEC, may be subject to an action for relief in several different fora if a party believes that small entity or incumbent LEC violated the standards under section 251 or 252. Should a small entity or a small incumbent LEC be subjected to such an action for relief, it will require the use of legal skills.

1364. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* We believe that our actions establishing minimum national rules will facilitate the development of competition in the local exchange and exchange

[3272] *See* 5 U.S.C. § 604(a)(4).

[3273] *See* 5 U.S.C. § 604(a)(5).

access markets for the reasons discussed in Sections II.A and II.B above. For example, national rules may: help equalize bargaining power; minimize the need for duplicative marketing strategies and multiple network configurations; lower administrative costs; lessen the need to re-litigate the same issue in multiple jurisdictions; and reduce delay and transaction costs, which can pose particular burdens for small businesses. In addition, our rules are designed to accommodate differences among regions and carriers, and the reduced regulatory burdens and increased certainty produced by national rules may be expected to minimize the economic impact of our decisions for all parties, including any small entities and small incumbent LECs. As set forth in Section II.A above, we reject suggestions to adopt more, or fewer, national rules than we ultimately adopt in this Order. We reject the arguments that we should establish "preferred outcomes" from which parties could deviate upon an adequate showing, or that we establish a process by which state commissions could seek a waiver from the Commission's rules, for the reasons set forth in Section II.B above.

1365. We believe that our determination that there are multiple methods for bringing enforcement actions against parties regarding their obligations under sections 251 and 252 will assist all parties, including small entities and small incumbent LECs, by providing a variety of methods and fora for seeking enforcement of such obligations. (Section II.E - Authority to Take Enforcement Action.) Similarly, our conclusion that Bell Operating Company (BOC) statements of generally available terms and conditions are governed by the same national rules that apply to agreements arbitrated under section 252 should ease administrative burdens for all parties in markets served by BOCs, which may include small entities, because they will not need to evaluate and comply with different sets of rules. (Section II.F - BOC Statements of Generally Available Terms.) Finally, we decline to adopt different requirements for agreements arbitrated under section 252 and BOC statements of generally available terms and conditions for the reasons set forth in section II.F above.

Summary Analysis of Section III
DUTY TO NEGOTIATE IN GOOD FAITH

1366. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Incumbent LECs, including small incumbent LECs that receive requests for access to network elements and/or services pursuant to sections 251 and 252 of the Act will be required to negotiate in good faith over the terms of interconnection agreements. As set forth in Section III.C. above, this Order identifies several practices as violations of the duty to negotiate in good faith, including: (1) a party's seeking or entering into an agreement prohibiting disclosure of information requested by the FCC or a state commission, or supplied in support of a request for arbitration pursuant to section 252(b)(2)(B); (2) seeking or entering into an agreement precluding amendment of the agreement to account for changes in federal or state rules; (3) an incumbent's denial of a reasonable request for cost data during negotiations; and (4) an entrant's failure to provide to the incumbent LEC information necessary to reach agreement. Complying with the projected requirements of this section may require the use of legal skills, as discussed above in

Section III.D. In addition, incumbent LECs and new entrants having interconnection agreements that predate the 1996 Act must file such agreements with the state commission for approval under section 252(e).

1367. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* As set forth above, we believe our decision to establish national rules and a review process concerning parties' duties to negotiate in good faith are designed to facilitate good faith negotiations, which should minimize regulatory burdens and the economic impact of our decisions for all parties, including small entities and small incumbent LECs. (Section III.B. - Advantages and Disadvantages of National Rules.) We also expect economic impacts to be minimized for small entities seeking to enter into agreements with incumbent LECs as a result of the decision that incumbent LECs may not impose a bona fide request requirement on carriers seeking agreements pursuant to sections 251 and 252. (Section III.C. - Specific Practices that may Constitute a Violation of Good Faith Negotiation.) For the reasons set forth in Section III.D. above, we also find that certain additional practices are not always violations of the duty to negotiate in good faith, including the suggested alternative that all nondisclosure agreements violate the good faith duty.

1368. We do not require immediate filing of preexisting interconnection agreements, including those involving small incumbent LECs and small entities. We set an outer time limit of June 30, 1997, by which preexisting agreements between Class A carriers must be filed with the relevant state commission. This decision will ensure that third parties, including small entities, are not prevented indefinitely from reviewing and taking advantage of the terms of preexisting agreements. It also limits burdens that a national filing deadline might impose on small carriers. In addition, the determination that preexisting agreements must be filed with state commissions seems likely to foster opportunities for small entities and small incumbent LECs to gain access to such agreements without requiring investigation or discovery proceedings or other administrative burdens that could increase regulatory burdens. (Section III.D. - Applicability of Section 252 to Preexisting Agreements). For the reasons set forth in Section III.D. above, we reject the alternative of not requiring certain agreements to be filed with state commissions.

Summary Analysis of Section IV
INTERCONNECTION

1369. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Incumbent LECs, including small incumbent LECs, are required by section 251(c) to provide interconnection to all requesting telecommunications carriers for the transmission and routing of telephone exchange service and exchange access service. Such interconnection must be: (1) provided at any technically feasible point; (2) at least equal in quality to that provided to the incumbent LEC itself and to any other parties with interconnection agreements; and (3)

provided on rates, terms, and conditions that are "just, reasonable, and nondiscriminatory . . . ."[3274] As set forth in Section IV.A. above, we conclude that interconnection refers solely to the physical linking of networks for the mutual exchange of traffic, and identify a minimum set of technically feasible points of interconnection. The minimum points at which an incumbent LEC, which may be a small incumbent LEC, must provide interconnection are: (1) the line side of a local switch; (2) the trunk side of a local switch; (3) the trunk interconnection points for a tandem switch; (4) central office cross-connect points; and (5) out-of-band signaling facilities. In addition, the points of access to unbundled elements (discussed below) are also technically feasible points of interconnection. Compliance with these requests may require the use of engineering, technical, operational, accounting, billing, and legal skills.

1370. To obtain interconnection pursuant to section 251(c)(2), telecommunications carriers must seek interconnection for the purpose of transmitting and routing telephone exchange traffic, or exchange access traffic, or both. (Section IV.E. - Definition of "Technically Feasible.") This will require new entrants to provide either local exchange service or exchange access service to obtain section 251(c)(2) interconnection. A requesting carrier will be required to bear the additional costs imposed on incumbent LECs as a result of interconnection. (Section IV.F. - Technically Feasible Points of Interconnection.) Carriers seeking interconnection, including small entities, may be required to collect information to refute claims by incumbent LECs that the requested interconnection poses a legitimate threat to network reliability. (*Id.*)

1371. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* The decision to adopt clear national rules in this section of the Order is also intended to help equalize bargaining power between incumbent LECs and requesting carriers, expedite and simplify negotiations, and facilitate comprehensive business and network planning. This could decrease entry barriers and provide reasonable opportunities for all carriers, including small entities and small incumbent LECs, to provide service in markets for local exchange and exchange access services. (Section IV.B. - National Interconnection Rules). National rules should also facilitate the consistent development of standards and resolution of issues, such as technical feasibility, without imposing additional litigation costs on parties, including small entities and small incumbent LECs. We determine that successful interconnection at a particular point in a network creates a rebuttable presumption that interconnection is technically feasible at other comparable points in the network. (Section IV.E - Definition of "Technically Feasible.") We also identify minimum points of interconnection where interconnection is presumptively technically feasible: (1) the line side of a switch; (2) the trunk side of a switch; (3) trunk interconnection points at a tandem switch; (4) central office cross-connect points; and (5) out-of-band signaling facilities. (Section IV.F - Technically Feasible Points of Interconnection.) These decisions may be expected to facilitate negotiations by promoting certainty and reducing transaction costs, which should minimize regulatory burdens

[3274] 47 U.S.C. § 251(c)(2).

and the economic impact of our decisions for all parties, including small entities and small incumbent LECs. We decline, however, to identify additional points where interconnection is technically feasible for the reasons set forth in section IV.F above.

1372. The ability to enter local markets by offering only telephone exchange service or only exchange access service may minimize regulatory burdens and the economic impact of our decisions for some entrants, including small entities. We decline, however, to interpret section 251(c)(2) as requiring incumbent LECs to provide interconnection to carriers seeking to offer only interexchange services for the reasons set forth in section IV.D. above. In addition, we determine that an incumbent LEC may refuse to interconnect on the grounds that specific, significant, and demonstrable network reliability concerns may make interconnection at a particular point sufficiently infeasible. We further determine that the incumbent LEC must prove such infeasibility to the state commission. (Section IV.E - Definition of "Technically Feasible.")

1373. Competitive carriers, many of whom may be small entities, will be permitted to request interconnection at any technically feasible point, and the determination of feasibility must be conducted without consideration of the cost of providing interconnection at a particular point. (Section IV.E. - Definition of "Technically Feasible.") Consequently, our rules permit the party requesting interconnection, which may be a small entity, and not the incumbent LEC to decide the points that are necessary to compete effectively. (Section IV.E. - Definition of "Technically Feasible"). We decline, however, to impose reciprocal terms and conditions for interconnection on carriers requesting interconnection. Our decision that an party requesting interconnection must pay the costs of interconnecting should minimize regulatory burdens and the economic impact of our interconnection decisions for small incumbent LECs. Similarly, regulatory burdens and the economic impact of our decisions may be minimized through the decision that, while a requesting party is permitted to obtain interconnection that is of higher quality than that which the incumbent LEC provides to itself, the requesting party must pay the additional costs of receiving the higher quality interconnection. (Section IV.H - Interconnection that is Equal in Quality.)

Summary Analysis of Section V
ACCESS TO UNBUNDLED NETWORK ELEMENTS

1374. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements*. Under section 251(c), incumbent LECs are required to provide nondiscriminatory access to unbundled network elements. We identify a minimum set of network elements: (1) local loops; (2) local and tandem switches; (3) interoffice transmission facilities; (4) network interface devices; (5) signaling and call-related database facilities; (6) operations support systems and functions; and (7) operator and directory assistance facilities. (Section V.J - Specific Unbundling Requirements.) Incumbent LECs are required to provide nondiscriminatory access to operations support systems and information by January 1, 1997. States may require incumbent LECs to provide additional network elements on an unbundled basis. As discussed in Section V.F. above, LECs must perform the functions necessary to combine unbundled elements in a

manner that allows requesting carriers to offer a telecommunications service, and the incumbent LEC may not impose restrictions on the subsequent use of network elements. Compliance with these requests may require the use of engineering, technical, operational, accounting, billing, and legal skills.

1375. If a requesting carrier, which may be a small entity, seeks access to an incumbent LEC's unbundled elements, the requesting carrier is required to compensate the incumbent LEC for any costs incurred to provide such access. For example, in the case of operation support systems functions, such work may include the development of interfaces for competing carriers to access incumbent LEC functions for pre-ordering, ordering, provisioning, maintenance and repair, and billing. Requesting carriers may also have to deploy their own operations support systems interfaces, including electronic interfaces, in order to access the incumbent LEC's operations support systems functions. The development of interfaces may require new entrants, including small entities, to perform engineering work. (Section V.J.5 - Operations Support Systems Unbundling.)

1376. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* The establishment of minimum national requirements for unbundled elements should facilitate negotiations and reduce regulatory burdens and uncertainty for all parties, including small entities and small incumbent LECs. National requirements for unbundling may allow new entrants, including small entities, to take advantage of economies of scale in network design, which may minimize the economic impact of our decision. As set forth in Section V.B, above, we reject several alternatives in making this determination, including proposals suggesting that the Commission should: (1) not identify any required elements; (2) allow the states exclusively to identify required elements; or (3) adopt an exhaustive list of elements.

1377. As set forth above, the 1996 Act defines a network element to include "all facilit(ies) or equipment used in the provision of a telecommunications service," and all "features, functions, and capabilities that are provided by means of such facility or equipment, including subscriber numbers, databases, signaling systems and information sufficient for billing and collection or used in the transmission, routing or other provision of a telecommunications service." (Section V.C - Network Elements.) As a result, new entrants, which may include small entities, should have access to the same technologies and economies of scale and scope that are available to incumbent LECs. In reaching our determination, we reject for the reasons set forth in Section V.C above, the following alternatives: (1) that we should not adopt a method for identifying elements beyond those identified in the 1996 Act; and (2) that features sold directly to end users as retail services are not network elements. Finally, we reject the argument that requesting carriers, which may include small entities, are required to provide all services typically furnished by means of an element they purchase. (*Id.*) Our rejection of this last alternative may reduce burdens for some small entities by permitting them to offer some, but not all, of the services provided by the incumbent LEC.

1378. We conclude that the requirement to provide "access" to unbundled network elements is independent of the interconnection duty imposed by section 251(c)(2), and that such "access" must be provisioned under the rates, terms and conditions applicable to unbundled network elements. We believe these conclusions may provide small entities seeking to compete with incumbent LECs with the flexibility to offer other telecommunications services in addition to local exchange and exchange access services. (Section V.D. - Access to Network Elements.) For the reasons set forth above in Section V.D, we reject the argument that incumbent LECs are not required to provide access to an element's functionality, and that "access" to unbundled elements can only be achieved by interconnecting under the terms of section 251(c)(2).

1379. As set forth above, we conclude that an incumbent LEC, which may be a small incumbent LEC, may decline to provide a network element beyond those identified by the Commission where it can demonstrate that the network element is proprietary, and that the competing provider could offer the proposed telecommunications service using other nonproprietary elements within the incumbent's network. (Section V.E - Standards Necessary to Identify Unbundled Network Elements.) This should minimize regulatory burdens and the economic impact of our decisions for incumbent LECs, including small incumbent LECs, by permitting such entities to retain exclusive use of certain proprietary network elements.

1380. We conclude that incumbent LECs: (1) cannot impose restrictions, requirements or limitations on requests for, or the sale or use of, unbundled network elements; (2) must provide requesting carriers with all of the functionalities of a particular element so that requesting carriers :an provide any telecommunications services that can be offered by means of that element; '3) must permit new entrants to combine network elements which new entrants purchase access o, if so requested; (4) must prove to a state commission that they cannot combine elements that re not ordinarily combined within an their network, or that are not ordinarily combined in that ıanner, because such combination is not technically feasible or it would impair the ability of :her carriers to access unbundled elements and interconnect with the incumbent LEC; and (5) ust provide the operational and support systems necessary to purchase and combine network :ements. As a result of these conclusions, many small entities should face significantly reduced ırriers to entry in markets for local exchange services. (Section V.F - Provision of a :lecommunications Service Using Unbundled Network Elements.) For the reasons set forth in :tion V.F, we reject the following alternatives: (1) that incumbent LECs, in all instances, must nbine elements that are not ordinarily combined in their networks; and (2) that incumbent Cs are not obligated to combine elements for requesting carriers.

1381. By establishing minimum national rules concerning nondiscriminatory access to undled network elements, requesting carriers, including small entities, may face reduced saction and regulatory costs in seeking to enter local telecommunications markets. Among e minimum rules are: (1) access and elements which new entrants receive are to be equal in ity between carriers; (2) incumbent LECs must prove technical infeasibility; (3) the rates, s and conditions established for the provisioning of unbundled elements must be equal

between all carriers, and where applicable, between requesting carriers and the incumbent LEC itself, and they must provide efficient competitors with a meaningful opportunity to compete; and (4) incumbent LECs must provide carriers purchasing unbundled elements with access to electronic interfaces if incumbents use such functions themselves in provisioning telecommunications services. (Section V.G - Nondiscriminatory Access to Unbundled Network Elements.)

1382. As set forth above, we conclude that section 251(c)(3) does not require new entrants to own or control their own local exchange facilities in order to purchase and use unbundled network elements and, thus, new entrants can provide services solely by recombining unbundled network elements. (Section V.H - The Relationship Between Sections 251(c)(3) and 251(c)(4).)

1383. As discussed in Section V.J above, we adopt a minimum list of required unbundled network elements that incumbent LECs, including small incumbent LECs, must make available to requesting carriers. In adopting this list, we sought to minimize the regulatory burdens and economic impact for small incumbent LECs. For example, we declined to adopt a detailed list including many additional elements, as set forth in Section V.B. We aiso provided for the fact that certain LECs may possess switches that are incapable of performing customized routing for competitors, as discussed in Section V.J.2.(c).(ii).

Summary Analysis of Section VI
METHODS OF OBTAINING INTERCONNECTION AND ACCESS TO UNBUNDLED NETWORK ELEMENTS

1384. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* We conclude that Section 251(c)(6) requires incumbent LECs, including small incumbent LECs, to provide for any technically feasible method of interconnection or access to unbundled network elements, including physical collocation, virtual collocation, and meet-point interconnection. With certain modifications, we adopt some of the requirements concerning physical and virtual collocation that we adopted in the *Expanded Interconnection* proceeding. Compliance with these requests may require the use of engineering, technical, operational, accounting, billing, and legal skills.

1385. In a meet-point arrangement the new entrant will build out facilities to the agreed-upon point, which will likely entail the use of engineering and installation personnel as well as the acquisition of equipment. We allow incumbent LECs to impose reasonable restrictions on the warehousing of space by collocators. Therefore, small entities collocating equipment may be required to use the provided space for the collocation of equipment necessary for interconnection or access to unbundled network elements or risk losing the right to use that space. (Section VI.B.1.e - Allocation of Space.) To take advantage of its right to collocate equipment on an incumbent LEC's premises, competitive entrants, which may include small entities, will be

required to build or lease transmission facilities between their own equipment, located outside of the incumbent LECs' premises, and the collocated space. (Section VI.B.1.f - Leasing Transport Facilities.) We allow incumbent LECs to require reasonable security arrangements to separate an entrant's collocation space from the incumbent LEC's facilities. Small entities collocating equipment may therefore be required to pay for such security arrangements. (Section VI.B.1.h - Security Arrangements.)

1386. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* By readopting our *Expanded Interconnection* terms and conditions, which allow competitors to collocate equipment for interconnection with the incumbent LEC, regulatory burdens have likely been reduced because the terms and conditions for collocation have already been established. (Section VI.B.1.b - Adoption of *Expanded Interconnection* Terms and Conditions.) This seems likely to benefit all parties, including small entities and small incumbent LECs, since it should reduce the time and expense of negotiation, and reduce the costs of adapting to new terms and conditions for collocation.

1387. Due to our conclusion that requesting carriers may choose any method of technically feasible interconnection or access to unbundled elements, new entrants, including small entities, should have the flexibility to obtain interconnection or access in the manner that best suits their needs. (Section VI.A. - Methods of Obtaining Interconnection and Access to Unbundled Elements.) In particular, as discussed in Section VI.A.3, we recognize that carriers, including small entities, may find virtual collocation or meet-point arrangements more efficient than physical collocation in certain circumstances, particularly if they lack the resources to collocate physically in a large number of incumbent LEC premises.

1388. We adopt a broad definition of the term "premises," which should allow carriers, including small entities, to collocate equipment for interconnection and access to unbundled network elements at a range of incumbent LEC locations. (Section VI.B.1.c - The Meaning of the Term "Premises.") For the reasons set forth in Section VI.B above, we interpret the term "premises" broadly to include incumbent LEC central offices, serving wire centers and tandem offices, as well as all buildings or similar structures owned or leased by the incumbent LEC that house incumbent LEC facilities. However, as set forth above, we reject the suggestion that security measures be provided only at the request of the entrant, which should minimize regulatory burdens and the economic impact of our decisions for small incumbent LECs. (*Id.*)

1389. We interpret the statute broadly to allow collocation of any equipment used for interconnection or access to unbundled network elements. (Section VI.B.1.d - Collocation Equipment.) This standard should offer all competitors, including small entities, flexibility in collocating equipment they need to interconnect their networks to those of incumbent LECs. Incumbent LECs will also be required to make space available to requesting carriers on a first-come, first-served basis, and collocators seeking to expand their collocated space should be allowed to use contiguous space where available. (Section VI.B.1.e - Allocation of Space.)

These provisions should minimize regulatory burdens and economic impacts for small entity entrants by reducing opportunities for discriminatory treatment based on the size of the requesting carrier. We decline, however, to require incumbent LECs to file reports on the status, planned increase, and use of space for the reasons set forth in Section VI.B.1. above, which will reduce the regulatory burdens and economic impact of our decisions for small incumbent LECs.

1390. We conclude that a competitive entrant should be permitted to lease transmission facilities from the incumbent LEC. (Section VI.B.1.f - Leasing Transport Facilities). This provision will allow small entities to lease transmission facilities from incumbent LECs to transmit traffic between the collocated space and their own networks, which may be comparatively less burdensome for small entities than the alternative of bringing their own facilities to the collocated equipment on the incumbent LEC's premises. We also require incumbent LECs to permit two or more carriers that are collocating at the incumbent LEC's premises to interconnect their networks. (Section VI.B.1.g - Co-Carrier Cross-Connect.) This requirement should make it easier for new entrants to interconnect their networks with those of competitors.

1391. We require incumbent LECs to provide the relevant state commissions with detailed floor plans or diagrams of any premises where the incumbent LEC alleges that there are space constraints. (Section VI.B.1.i. - Allowing Virtual Collocation in Lieu of Physical). This requirement may reduce burdens for all parties, including small entities and small incumbent LECs, by aiding state commissions with their evaluation of incumbent LEC refusals to allow physical collocation on the grounds of space constraints. For the reasons set forth in Section VI.B.1 above, however, we decline to require incumbent LECs to lease additional space or provide trunking at no cost where they have insufficient space for physical collocation, which should minimize the regulatory burdens and economic impact of our decisions for incumbent LECs, including small incumbent LECs.

Summary Analysis of Section VII
PRICING OF INTERCONNECTION
AND UNBUNDLED NETWORK ELEMENTS

1392. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* Pursuant to sections 251(c) and 252(d) of the 1996 Act, incumbent LECs must provide interconnection and access to unbundled network elements on rates, terms, and conditions that are just, reasonable, and nondiscriminatory. In Section VII above, we adopt a methodology for setting arbitrated prices for interconnection and unbundled elements on the basis of forward-looking economic cost studies prepared in conformance with a methodology prescribed by the Commission. Until states utilize economic studies to develop cost-based prices, they must use default proxies established by the Commission. Small incumbent LECs may be required, therefore, to prepare economic cost studies. In addition, small entities seeking arbitration for rates for interconnection or unbundled elements may find it useful to prepare economic cost

studies or prepare critiques of cost studies prepared by incumbent LECs and others. In both cases, this may entail the use of economic experts, legal advice, and possibly accounting personnel.

1393. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* Our conclusion that prices for interconnection and unbundled elements should be set at forward-looking long-run economic cost, including a reasonable share of forward-looking joint and common costs, should permit new entrants, including small entities, to interconnect with, and acquire unbundled elements from, incumbent LECs at prices that replicate, to the extent possible, those in a competitive market. (Section VII.B.2 - Pricing of Interconnection and Unbundled Elements, Cost-Based Pricing Methodology, Rate Levels.) Our forward-looking economic cost methodology for determining prices is designed to permit incumbent LECs to recover their economic costs of providing interconnection and unbundled elements, which should minimize the economic impact of our decisions on small incumbent LECs.

1394. Our conclusion that embedded costs, opportunity costs and universal service subsidies may not be included in the rates for interconnection and unbundled elements is intended, in part, to avoid distortions in investment decisions, which should lead to more efficient allocation of resources, thereby reducing regulatory burdens and economic impacts for some small entities and small incumbent LECs. (Section VII.B.2 - Pricing of Interconnection and Unbundled Elements, Cost-Based Pricing Methodology, Rate Levels.) We reject proposals that would have permitted incumbent LECs to recover their embedded costs in prices for interconnection and unbundled elements as discussed above in Section VII.B.2.a.(3)(b). As discussed in Section VII.B.2.a.(3)(b), we reject the use of the efficient component pricing rule (ECPR) to set prices for interconnection and unbundled elements.

1395. Our conclusion that forward-looking common costs should be allocated in a reasonable manner should ensure that the prices of network elements that are least likely to be subject to competition are not artificially inflated by large allocations of common costs. This, in turn, may also produce more efficient allocations of resources, thereby minimizing regulatory burdens and economic effects for many parties, including small entities and small incumbent LECs. (Section VII.B.2 - Pricing of Interconnection and Unbundled Elements, Cost-Based Pricing Methodology, Rate Levels.) We permit, but do not require, states to impose peak-sensitive pricing systems for shared facilities as discussed in Section VII.B.3.b.

1396. We conclude that incumbent LECs should not recover access charges from entrants that use unbundled network facilities to provide access services to customers that they win from incumbent LECs. We do, however, permit incumbent LECs to impose on purchasers of unbundled local switching the carrier common line charge and a charge equal to seventy-five percent of the transport interconnection charge for an interim period that shall end no later than June 30, 1997, as discussed in Section VII.B.2.a.(3)(b). As further explained in that section, this

mechanism should serve to reduce any short-term disruptive impact of our decisions on incumbent LECs, including small incumbent LECs.

1397. We conclude that the Act requires rates for interconnection and unbundled elements to be geographically deaveraged, using a minimum of three geographic zones, in a manner that appropriately reflects the costs of the underlying elements. (Section VII.B.3.c. - Geographic/Class-of-Service Averaging.) We also conclude that distinctions between the rates charged to requesting carriers for network elements should not vary based on the classes of service that the requesting carriers provide to their to customers. We expect these decisions to lead to increased competition and a more efficient allocation of resources.

1398. The default proxies we adopt for rates for interconnection and unbundled elements, which states may use to establish prices, are designed to approximate prices that will enable efficient competitors, including small entities, to enter local exchange markets. (Section VII.C. - Default Proxy Ceilings and Ranges.) We reject the use of rates in interconnection agreements that predate the 1996 Act as proxy-based ceilings for interconnection and unbundled element rates as discussed in Section VII.C.1. We also decline to adopt a generic cost model at this time, as discussed in Section VII.C.3.

1399. We determine that the nondiscrimination provisions in the Act prohibit price differences that are not based on cost differences. This should permit small entities to obtain the same terms and conditions of agreements reached by larger carriers that possess greater bargaining power without having to incur the costs of negotiation and/or arbitration. (Section VII.D.3 - Discrimination.)

Summary Analysis of Section VIII
RESALE

1400. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* Pursuant to section 251(b)(1), all LECs, which may include small entity competing LECs and small incumbent LECs, may not impose unreasonable or discriminatory conditions on, or limit the resale of, their telecommunications services. Pursuant to section 251(c)(4), incumbent LECs are required to offer for resale at wholesale rates any telecommunications services that they offer to subscribers other than telecommunications carriers. Providing such services for resale may require some small entities and small incumbent LECs to use additional billing, technical, and operational skills.

1401. Under section 252(a), resellers, which may include small entities, are required to prepare and present to incumbent LECs requests for services to resell. We do not establish guidelines for the content of these requests. Such requests may involve legal, engineering, and accounting skills. Resellers may also have to engage in arbitration proceedings with incumbent LECs if voluntary negotiations resulting from the initial request fail to yield an agreement. This

may involve legal and general negotiation skills. Where a reseller is negotiating or arbitrating with an incumbent LEC, the reseller may choose to offer arguments concerning economic and accounting data presented by state commissions or incumbent LECs. Resellers may also choose to make legal and economic arguments that certain resale restrictions are unreasonable. These tasks may require legal, economic, and accounting skills.

1402. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* As set forth in Section VIII.B, above, our decision to adopt clear national rules should reduce regulatory burdens and uncertainty for all parties, including small entities and small incumbent LECs. Moreover, our decision not to impose eligibility requirements on resellers should minimize regulatory burdens for resellers. We reject proposals that the Commission not require resale of bundled service offerings, promotions and discounts lasting longer than 90 days, residential service, and services offered at rates below cost for reasons set forth in Section VIII.A.

1403. As discussed in Section VIII.B, we expect that the opportunity to resell telecommunications services currently offered exclusively by incumbent LECs will lead to increased competition in the provision of telecommunications services. We also determine that non-cost-based factors shall not be considered when arriving at wholesale discounts, and we reject the argument that indirect costs should not be considered avoided costs. We also reject proposals that we either require or forbid a state to include a measure of profit in its avoided cost calculation. As set forth in Section VIII.B, we considered the concerns of small incumbent LECs and small entity resellers when adopting the default range for wholesale discounts. In addition, we allow a state to consider including in wholesale rates the costs that incumbent LECs incur in selling services on a wholesale basis, which may minimize the economic impact for small incumbent LECs.

1404. As discussed in Section VIII.C, we remove obstacles faced by small businesses in reselling telecommunications services by establishing a presumption, applicable to incumbent and non-incumbent LECs, that most restrictions on resale are unreasonable. This presumption should reduce unnecessary burdens on resellers, which may include small entities. It may also produce increased opportunities for resale competition, which may be expected to be beneficial for some small entities and small incumbent LECs. We do not permit state commissions to require non-incumbent LECs to offer their services at wholesale rates for the reasons set forth Section VIII.D. For the reasons discussed in Section VIII.C, above, we decline to forbear from the application of section 251(b)(1) to non-incumbent LECs. We also conclude that incumbent LECs are to continue to receive access charge revenues when local services are resold under section 251(c)(4) for reasons set forth in Section VIII.E, and that such access services are not subject to resale at wholesale rates for reasons set forth in Section VIII.A.

Summary Analysis of Section IX
DUTIES IMPOSED ON "TELECOMMUNICATIONS CARRIERS" BY SECTION 251(a)

1405. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* Small entities that provide telecommunications services are subject to the same obligations imposed on all telecommunications carriers under section 251(a)(1) and section 251(a)(2), and any reporting requirements that attend such obligations. Among these duties is the duty to interconnect, directly or indirectly, with requesting telecommunications carriers. (Section IX - Duties Imposed on "Telecommunications Carriers" By Section 251(a).) This will likely require small entities to comply with the technical, economic, and legal requirements involved with interconnection, including negotiating contracts, utilizing engineering studies, and adding operational capacity. (*Id.*) Small incumbent LECs may incur similar compliance requirements to the extent they are required to interconnect with entities that qualify as "telecommunications carriers."

1406. Small incumbent LECs and small entities providing telecommunications services will also be under a duty not to install network features, functions, and capabilities that do not comply with standards and guidelines under sections 255 and 256. (Section IX - Duties Imposed on "Telecommunications Carriers" By Section 251(a)(2).) In addition, small entities that provide both information services and telecommunications services are classified as telecommunications carriers and are subject to certain requirements under 251(a). (Section IX - Duties Imposed on "Telecommunications Carriers" By Section 251(a)(2).)

1407. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* Small entities who provide for a fee local, interexchange and international services are defined as telecommunications carriers and, thus, also receive the benefits of section 251 including interconnection, services, and network elements, which may increase their ability to compete. (Section IX - Duties Imposed on "Telecommunications Carriers" By Section 251(a)(2).) We reject the suggestion that CMRS providers, some of which likely are small entities, should not be included in the definition of a "telecommunications carrier." (*Id.*) We determine that entities operating private, internal or shared communications networks do not qualify as telecommunications carriers, however, which excludes them from the obligations and benefits under section 251(a). Small entities providing information services but not telecommunications services are also not classified as telecommunications carriers and, thus, will not be bound by the duties of section 251(a). A carrier that provides both information and telecommunications services is deemed subject to the requirements of section 251(a). We also conclude that telecommunications carriers that have interconnected under either section 251(a)(1) or 251(c)(2) may offer information services through the same arrangement or agreement. This will permit new entrants, many of which may be small entities, to offer full ranges of services to end users without having to provide some of those services inefficiently through distinct facilities or agreements.

1408. We decide that competitive telecommunications carriers that have the obligation to interconnect with requesting carriers may choose, based upon their own characteristics, whether to allow direct or indirect interconnection. (Section IX - Duties Imposed on "Telecommunications Carriers" By Section 251(a).) This should allow significant flexibility for small entities to choose the most efficient and economical arrangement for their particular strategy. As set forth in Section IX, we reject an argument to forbear, under section 10 of the Communications Act,[3275] from imposing any interconnection requirements on non-dominant carriers.

Summary Analysis of Section X
COMMERCIAL MOBILE RADIO SERVICES

1409. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* We are applying sections 251 and 252 to LEC-CMRS interconnection at this time. (Section X.D - Jurisdictional Authority for Regulation of LEC-CMRS Interconnection Rates.) We may revisit our determination not to invoke jurisdiction under section 332 to regulate LEC-CMRS interconnection rates if we determine that the regulatory scheme established by sections 251 and 252 does not sufficiently address the problems encountered by CMRS providers, many of which may be small entities, in obtaining interconnection on terms and conditions that are just, reasonable, and nondiscriminatory.

1410. Pursuant to our findings in Section X.D, a small CMRS entity seeking to enter into a reciprocal compensation agreement with an incumbent LEC, which may be a small incumbent LEC, will have to comply with sections 251 and 252, and state law. The reporting, recordkeeping, and other compliance requirements associated with reciprocal compensation are summarized in the following section concerning obligations under section 251(b).

1411. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* The Commission's actions may minimize the economic impact on CMRS providers, many of which are small entities, by declaring that CMRS providers are not required to comply with the obligations of LECs under section 251(b)(5). We decline to adopt the alternative of finding that a CMRS provider is a LEC for the reasons set forth in Section X.A. We also determine that CMRS providers are entitled to request reciprocal compensation under section 251(b)(5), and that certain CMRS providers are also entitled to request interconnection under section 251(c)(2). As discussed in the following section concerning obligations under section 251(b), these decisions may permit small entity CMRS providers the opportunity to considerably expand their businesses.

Summary Analysis of Section XI
OBLIGATIONS IMPOSED ON LECS BY 251(b)

[3275] 47 U.S.C. § 160.

A. Reciprocal Compensation for Transport and Termination of Telecommunications

1412. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* All local exchange carriers, including small incumbent LECs and perhaps some small entities offering competing local exchange services, have a duty to establish reciprocal compensation for the transport and termination of local telecommunications traffic, as defined by state commissions. As such, small incumbent LECs and small entities offering competitive local exchange services may be required to measure the exchange of traffic, and to bill and collect payment from other carriers. (Section XI.A - Reciprocal Compensation for Transport and Termination of Telecommunications.) Reciprocal compensation for the transport and termination of traffic may be based on the incumbent LEC's cost studies, which may require small incumbent LECs to use economic skills to perform cost studies. To the extent that a competing provider of local exchange services, which may include a small entity, believes its costs for the transportation and termination of traffic differ from those of the incumbent LEC, it would also be required to provide a forward-looking, economic cost study. (*Id.*)

1413. If a CMRS provider entered into an agreement with an incumbent LEC prior to August 8, 1996 that does not provide for mutual compensation, the CMRS provider may demand to renegotiate the agreement. This may impose the burden of re-negotiation on small incumbent LECs, which may require legal, accounting, and economic skills. In addition, pending the successful completion of negotiation or arbitration, symmetrical reciprocal compensation shall apply, which may have the effect of raising the amount small incumbent LECs currently pay CMRS providers to terminate LEC-originated traffic. This may have the effect of increasing small incumbent LECs' costs. Finally, a state commission may impose bill-and-keep arrangements between carriers if the state commission determines that the amount of local telecommunications traffic from one network to the other is approximately equal to the amount of local telecommunications traffic flowing in the opposite directions, and is expected to remain thus. This could have the effect of reducing small incumbent LECs' revenues and decreasing the expenses of small entities. It also might place a burden on small entities and small incumbent LECs of establishing that traffic volumes are imbalanced, which might require accounting, economic, and legal skills.

1414. We require paging companies seeking to recover fees for terminating local calls to demonstrate to the state the costs of terminating such calls. (Section XI.A. - Reciprocal Compensation for Transport and Termination of Traffic.) Consequently, small entity paging companies and possibly small incumbent LECs may be required to use legal, economic, and possibly accounting skills.

1415. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* Our adoption of national default price ceilings and ranges for transportation and termination of local traffic being arbitrated by the states should

provide all parties, including small incumbent LECs and many new entrant small entities, with a clear understanding of the terms and conditions that will govern should they fail to reach an agreement. This should minimize regulatory burdens and economic impacts for those companies, in part by reducing the transaction costs of arbitration. (Section XI.A.3.c.(4) - Default Proxies.) Permitting CMRS providers with non-reciprocal agreements to renegotiate their agreements, and imposing symmetrical reciprocal compensation pending completion of negotiation or arbitration, will provide all parties with certainty as to applicable rates as of the date of this order, and minimize litigation and regulatory costs. We believe this decision is consistent with the pro-competitive goals of the 1996 Act.

1416. We define transport and termination as separate functions -- each with its own cost calculation for the purposes of sections 251 and 252. This definition may permit interconnecting carriers, including small entities, to obtain transport and termination services at lower rates and avoid paying above-cost rates or rates for unneeded services. (Section XI.A.2 - Definition of Transport and Termination of Telecommunications.) We also conclude that a LEC may not charge a CMRS provider or other carrier, which may be a small entity, for receiving and terminating LEC-originated traffic. (Section XI.A.4 - Symmetry.) We do not permit interexchange carriers to use transport and termination services to avoid the obligation to pay access charges for terminating interexchange traffic with incumbent LECs. (Section XI.A.2 - Definition of Transport and Termination of Telecommunications.)

1417. Our decision to permit new entrants to base reciprocal compensation arrangements on incumbent LECs' cost studies may reduce barriers to entry by permitting competing LECs to avoid performing their own forward-looking, economic cost studies, which may be expected to reduce the overall burdens and minimize the economic impact of regulation on these small entities. (Section XI.A.4 - Symmetry.) The ability of state commissions to impose bill and keep arrangements where the costs of terminating traffic are nearly symmetrical, traffic volume is roughly balanced, and both are expected to remain so, may allow small entities and small incumbent LECs to avoid the cost of measuring traffic exchange. (Section XI.A.5 - Bill and Keep.) For the reasons set forth in Section XI.A.5 above, we reject the proposed alternative of permitting states to adopt bill-and-keep arrangements for the transport and termination of traffic where the cost of terminating traffic is not nearly symmetrical.

1418. By requiring that rates for transport and termination be cost based, we believe that all parties in telecommunications markets, including small incumbent LECs and small entities, may benefit from increased opportunities to compete effectively in local exchange markets. (Section XI.A.3 - Pricing Methodology.) In addition, we conclude that termination rates for LECs, including small incumbent LECs, should include an allocation of forward-looking common costs, but not an element for the recovery of lost contributions. These decisions may be expected to minimize the economic impact of our decisions on small incumbent LECs and small entities.

1419. This Order eliminates certain charges paging companies may now be assessed by LECs and enables paging companies to claim new revenues from LECs for terminating paging calls. (Section XI.A - Reciprocal Compensation for Transport and Termination of Traffic.) Paging companies, including small entities, may thereby incur lower costs. Such entities also may increase their revenues, depending on the outcome of any proceedings concerning their termination costs. For the reasons set forth in Section XI.A.3 above, we cannot conclude, at this time, that a LEC's forward looking costs may be used as a reasonable proxy for the costs of call termination by paging providers. We further conclude that the default price for termination of traffic from the end office that we adopt in this proceeding in Section XI.A.3 above does not apply to termination of traffic by paging providers. This default price is based on estimates in the record of the costs to LECs of termination from the end office or end-office switching.

B. Access to Rights-of-Way

1420. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* Small incumbent LECs that meet the definition of a utility[3276] and own poles, ducts, conduits and rights-of-way where access was not previously mandated are now required to provide access to requesting telecommunications carriers (other than incumbent LECs and cable television systems) which may require the use of legal, engineering, and accounting resources for evaluation and processing of attachment requests. (Section XI.B.2 - Section 224(f): Non-discriminatory Access.) This may also require small incumbent LECs and small entities to employ technical personnel to modify pole attachment arrangements.

1421. A complaint of unjustified denial of access must be supported by a written request for access, the utility's response, and information supporting the complainant's position. This will likely impose some recordkeeping requirements on small incumbent LECs and small entities seeking access to rights-of-way. Our requirements may also impose administrative requirements, including legal and engineering expertise, on small governmental jurisdictions[3277] that resolve disputes arising under section 224 of the Communications Act. (Section XI.B.5 - Dispute Resolution.) In addition, small governmental jurisdictions that have established rules and regulations for access to poles, ducts and conduits specifically, and interconnection generally, are also likely to have some level of reporting and recordkeeping requirements for competing telecommunications carriers that use the poles, some of which may be small entities. (Section XI.B.6 - Reverse Preemption.)

[3276] The Act defines "utility" as "any person who is a local exchange carrier or an electric, gas, water, steam, or other public utility, and who owns or controls poles, ducts, conduits, or rights-of-way used, in whole or in part, for any wire communication." 47 U.S.C. § 224(a)(1).

[3277] Under the Regulatory Flexibility Act, a "small governmental jurisdiction" is one type of "small entity," and is defined as the "governments of cities, counties, towns, townships, villages, school districts, or special districts with a population of less than fifty thousand . . . ." 5 U.S.C. § 601(5).

1422. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* In placing the burden of proof on the denying utility with respect to the propriety of a denial of access, we recognize that new entrants, which may be small entities, are not likely to have access to such information without cooperation from the utilities. Complaints should not be dismissed where the petitioner was unable to obtain a written response from the denying utility, or where the utility also denied the petitioner any relevant information needed to establish a prima facie case. These provisions should allow an entrant to pursue a claim without the need for expensive discovery, and should not preclude or discourage entities with limited resources from seeking redress where access is denied. (Section XI.B.5 - Dispute Resolution.) For the reasons set forth in Section XI.B.5, we reject the recommendation that an applicant be allowed to seek injunctive relief in federal court and select federal jurisdiction for enforcement or appeal of any matter regarding pole attachments. Our conclusion that state and local pole attachment requirements are presumed reasonable may minimize burdens on small governmental jurisdictions by preserving existing rules and procedures, and the local government's expertise with its own rules. (Section XI.B.2.c.2. - Specific Rules.) In reaching this result, we reject the alternative of invalidating such state regulations in favor of federal rules for the reasons stated in Section XI.B.2. Our determination not to prescribe numerous specific rules in this area recognizes the varying technologies and facilities deployed by incumbent LECs, including small incumbent LECs. For example, we recognize that utilities, including small incumbent LECs, normally have their own operating standards that dictate conditions of access. Thus, we leave in place such conditions of access. For the reasons set forth in Section XI.B., we reject the alternative of prescribing a comprehensive set of substantive engineering standards governing access to rights-of-way.

1423. When an attaching entity modifies poles for its use, it will be entitled to recover a share of its expenses from any later-attaching entities. (Section XI.B.4 - Modifications.) This should permit attaching entities that modify poles, some of which may be small entities, to bear only their proportionate costs and prevent them from effectively subsidizing their later-entering competitors. The requirement that utilities provide attaching entities with 60 days' notice prior to commencing modifications to any pole, duct or conduit should provide attaching entities, some of which may be small entities, with sufficient time to evaluate the impact of the proposed modification on their interests and to plan and coordinate any modifications to their own attachments. (*Id.*)

C. Imposing Additional Obligations on LECs

1424. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Our decisions in this section of the Order do not subject any small entities to reporting, recordkeeping or other compliance requirements.

1425. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* The determination that the 1996 Act does not

permit the particular obligations for incumbent LECs set forth in section 251(c) to be imposed on non-incumbent carriers, absent a finding by the Commission under section 251(h)(2), should limit potential burdens on new entrants, including small entities. (Section XI.C - Imposing Obligations on LECs.)

Summary Analysis of Section XII
EXEMPTIONS, SUSPENSIONS AND
MODIFICATIONS OF SECTION 251 REQUIREMENTS

1426. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Section 251(f)(1) grants rural telephone companies, which may be small incumbent LECs, an exemption from the requirements of section 251(c) (which only apply to incumbent LECs) until the rural telephone company has received a bona fide request for interconnection, services, or network elements, and the state determines that the exemption should be terminated. Section 251(f)(2) provides that LECs with fewer than two percent of the nation's subscriber lines may petition a state commission for a suspension or modification of any requirements of sections 251(b) and 251(c). The latter provision, section 251(f)(2), is available to all LECs including competitive LECs, which may be small entities.

1427. After a carrier has made a bona fide request under Section 251, a rural telephone company, which may be a small incumbent LEC, seeking to retain its exemption under section 251(f)(1) must prove to the state commission that it should retain its exemption. To remove the exemption, a state commission must find that the bona fide interconnection request is not unduly economically burdensome, is technically feasible, and is consistent with section 254. The parties involved in such a proceeding may need to use legal, accounting, economic and/or engineering services. A small incumbent LEC or a competitive LEC, which may be a small entity, seeking under 251(f)(2) to modify or suspend the national interconnection requirements imposed by section 251(b) or 251(c) bears the burden of proving that interconnection would: (1) create a significant adverse economic impact on telecommunications users; (2) be unduly economically burdensome; or (3) be technically infeasible.

1428. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* As set forth in Section XII above, the determination whether a section 251(f) exemption, suspension, or modification should be continued or granted lies primarily with the relevant state commission. By largely leaving this determination to the states, our decisions permit this fact-specific inquiry to be administered in a manner that minimizes regulatory burdens and the economic impact on small entities and small incumbent LECs. However, to further minimize regulatory burdens and minimize the economic impact of our decision, we adopt several rules as set forth in Section XII above, which may facilitate the efficient resolution of such inquiries, provide guidance, and minimize uncertainty. As set forth in Section XII above, we find that the rural LEC or smaller LEC must prove to the state commission that the financial harm shown to justify an exemption, suspension, or

modification would be greater than the harm that might typically be expected as a result of competition. Finally, we conclude that section 251(f) adequately provides for varying treatment for smaller or rural LECs where such variances are justified. As a result, we expect that section 251(f) will significantly minimize regulatory burdens and economic impacts from the rules adopted in this Order.

Summary Analysis of Section XIII
ADVANCED TELECOMMUNICATIONS CAPABILITIES

1429. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Our decision to defer consideration of rules in this section of the Order does not subject any small entities or small incumbent LECs to reporting, recordkeeping or other compliance requirements.

1430. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* We do not anticipate that our decision to defer consideration of rules in this section of the Order will have any economic impact on small entities or small incumbent LECs.

Summary Analysis of Section XIV
PROVISIONS OF SECTION 252

A. Section 252(e)(5)

1431. *Summary of Projected Reporting, Recordkeeping, and Other Compliance Requirements.* Pursuant to section 252(b)(1), a party to negotiation may petition a state commission to arbitrate any open issues. Small entities and small incumbent LECs negotiating interconnection agreements may, therefore, participate in state arbitration in order to obtain an interconnection agreement, which may impose significant legal costs. (Section XIV.A - Section 252(e)(5).) Section 252(e)(5) requires the Commission to assume the state's responsibility under section 252 if the state "fails to act to carry out its responsibility" under the section. We require an aggrieved party, which may be a small entity or a small incumbent LEC, to notify the FCC that a state commission has failed to act under section 252 by filing a detailed written petition, backed by affidavit. As set forth above in Section XIV.A, if the Commission, following a notice and comment period, determines that the state has failed to act, the Commission will assume authority under section 252(e)(5) and mediate or arbitrate the dispute. This process may also entail significant legal expertise.

1432. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* In this Order, the Commission adopts a minimum set of rules that will provide notice of the standards and procedures that the Commission will use if it has to assume the responsibility of a state commission under section 252(e)(5). These rules

should benefit small entities and small incumbent LECs by limiting uncertainty and minimizing transaction costs associated with the arbitration process. (Section XIV.A - 252(e)(5).)

1433. The Commission concludes that, if it arbitrates agreements, it will use a "final offer" arbitration method, whereby each party to the arbitration proposes its best and final offer, and the arbitrator chooses between the proposals. The arbitrator may choose either proposal in its entirety, or could choose different parties' proposals on an issue-by-issue basis. This method of arbitration should minimize the economic impact on small entities and small incumbent LECs by reducing the transaction costs associated with arbitration. Our rules should also encourage parties, to negotiate after offers are submitted which should provide additional flexibility for parties including small entities and small incumbent LECs, to agree to a resolution tailored to their interests. (Section XIV.A - 252(e)(5).)

1434. For the reasons set forth above in Section XIV.A, we reject the alternative of adopting national rules governing state arbitration procedures. We believe the states are in a better position to develop mediation and arbitration rules that support the objectives of the 1996 Act. States may develop specific measures that best address the concerns of small entities and small incumbent LECs participating in mediation or arbitration.

1435. As set forth above in Section XIV.A, we reject the suggestion that the Commission return jurisdiction over an arbitration to the state commission. We further reject the argument that, once the Commission has mediated or arbitrated an agreement, the agreement must be submitted to the state commission for approval under state law. We decline to adopt the alternative suggested by some parties that, if the Commission steps into the state commission role, it is bound by state laws and standards that would have applied to the state commission. (Section XIV.A - 252(e)(5)).

1436. As explained above in Section XIV.A, we also reject the alternative that an arbitrated agreement not be binding on the parties. Finally, we reject the alternative of opening the arbitration process to all third parties, which should minimize the costs involved in such proceedings.

B. Requirements of Section 252(i)

1437. *Summary of Projected Reporting, Recordkeeping and Other Compliance Requirements.* Our decisions in this section of the Order do not subject any small entities to reporting, recordkeeping or other compliance requirements. Incumbent LECs, including small incumbent LECs, are required to file with state commissions all interconnection agreements entered into with other carriers, including adjacent incumbent LECs. Incumbent LECs must also permit third parties to obtain any individual interconnection, service or network element arrangement on the same terms and conditions as those contained in any agreement approved under section 252. Moreover, incumbent LECs must prove with specificity that terms and

conditions contained in filed agreements are legitimately related to the purchase of the individual element or service being sought. Incumbent LECs must provide "most favored nation" status with regard to subsequent carriers regardless of whether they include "most favored nation" clauses in their agreements. Complying with these requirements may require small incumbent LECs and requesting small entities to use legal and negotiation skills.

1438. *Steps Taken to Minimize Significant Economic Impact on Small Entities and Small Incumbent LECs, and Alternatives Considered.* Our decision to adopt national standards to implement section 252(i) should minimize the economic impact of our decision on both small entities and small incumbent LECs by expediting the resolution of disputes, thereby reducing transaction costs associated with interconnection. Our decision that section 252(i) permits requesting carriers to choose among individual provisions contained in publicly-filed interconnection agreements should minimize the economic impact for small new entrants by permitting them to obtain the provisions they desire without having to adopt entire agreements that would not reflect their costs or the specific technical characteristics of their networks. (Section XIV.B - Requirements of Section 252(i).) Moreover, small entities may be able to obtain the same terms and conditions of agreements reached by larger carriers that possess greater bargaining power without having to incur the costs of negotiation and/or arbitration.

1439. We also determine that publicly-filed agreements need only be made available to carriers who cause incumbent LECs to incur no greater costs than did the original carrier, which should minimize the economic impact on small incumbent LECs. We also minimize the regulatory burden for small entities and small incumbent LECs by finding that a new entrant seeking interconnection, network elements, or services pursuant to section 252(i) need not make such requests pursuant to the procedures for initial section 251 requests, but shall be permitted to obtain access to agreements on an expedited basis.

1440. As set forth above, we conclude that section 252(i) permits differential treatment of carriers based on differences in the costs of serving those carriers, but does not permit incumbent LECs to limit the availability of interconnection, services, or network elements only to those requesting carriers serving a comparable class of subscribers or providing the same service as the original party to the agreement. (Section XIV.B. - Requirements of Section 252(i).) These decisions should minimize the impact on small entities by preventing discrimination and enabling them to obtain the same terms and conditions as larger carriers that possess greater bargaining power. For the reasons set forth in Section XIV.B., we reject the interpretation favored by commenters arguing that new entrants should not be able to choose among provisions of interconnection agreements filed with state commissions.

E. Report to Congress

1441. The Commission shall send a copy of this FRFA, along with this Order, in a report to Congress pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996, 5

U.S.C. § 801(a)(1)(A). A copy of this FRFA will also be published in the Federal Register.

XVI. ORDERING CLAUSES

1442. Accordingly, IT IS ORDERED that, pursuant to Sections 1-4, 201-209, 214, 218, 224, 251, 252, and 303(r) of the Communications Act of 1934, as amended, and Section 601 of the Telecommunications Act of 1996, 47 U.S.C. §§ 151-154, 201-209, 214, 218, 224, 251, 252, 303(r), the REPORT AND ORDER IS ADOPTED, effective 30 days after publication of a summary in the Federal Register. The collections of information contained within are contingent upon approval by the Office of Management and Budget.

1443. IT IS FURTHER ORDERED that Part 51 of the Commission's rules, 47 C.F.R. § 51 is ADDED as set forth in Appendix B hereto.

1444. IT IS FURTHER ORDERED that, to the extent issues from CC Docket No. 95-185, *In the Matter of Interconnection Between Local Exchange Carriers and Commercial Mobile Service Providers*, are resolved here, we incorporate the relevant portions of the record in that docket.

1445. IT IS FURTHER ORDERED that, to the extent issues from CC Docket No. 91-346, *In the Matter of Intelligent Networks*, are resolved here, we incorporate the relevant portions of the record in that docket.

1446. IT IS FURTHER ORDERED, in light of the United States Court of Appeals for the District of Columbia Circuit in *Pacific Bell v. FCC*, 81 F.3d 1147 (D.C. Cir. 1996) (table) and the Telecommunications Act of 1996, that the rules and policies adopted in *Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, 9 FCC Rcd 5154 (1994), shall remain in effect.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton
Acting Secretary

List of Commenters in CC Docket No. 96-98

360o Communications Company (360 Communications)
Ad Hoc Coalition of Corporate Telecommunications Managers
Ad Hoc Telecommunications Users Committee
AirTouch Communications, Inc. (AirTouch)
Alabama Public Service Commission (Alabama Commission)
Alaska Telephone Association (Alaska Tel. Ass'n)
Alaska Public Utilities Commission (Alaska Commission)
Alliance for Public Technology
Allied Association Partners, LP & Geld Information Systems (Allied Ass'n)
ALLTEL Telephone Services Corporation (ALLTEL)
American Communications Services, Inc. (ACSI)
American Foundation for the Blind
American Mobile Telecommunications Association, Inc. (American Mobile Telecomm. Ass'n)
American Network Exchange, Inc. & U.S. Long Distance, Inc. (American Network Exchange)
American Personal Communications
American Petroleum Institute
American Public Communications Council
American Public Power Association (APPA)
America's Carriers Telecommunication Association (ACTA)
Ameritech
Anchorage Telephone Utility (Anchorage Tel. Utility)
Arch Communications Group, Inc. (Arch)
Arizona Corporation Commission (Arizona Commission)
Association for Study of Afro-American Life and History, Inc. (ASALH)
Association for Local Telecommunications Services (ALTS)
Association of Telemessaging Services International
AT&T Corp. (AT&T)
Attorneys General of Connecticut, Delaware, Illinois, Iowa, Massachusetts, Michigan, Minnesota, Missouri, New York, North Dakota, Pennsylvania, West Virginia and Wisconsin (Attorneys General)
Bay Springs Telephone Co., Crockett Telephone Co., National Telephone Company of Alabama, Peoples Telephone Company, Roanoke Telephone Co. & West Tennessee Telephone Company (Bay Springs, *et al.*)
Black Data Processing Associates
Black Data Processors Association (Black Data Processors Ass'n)
Bell Atlantic Telephone Companies (Bell Atlantic)
Bell Atlantic NYNEX Mobile, Inc. (Bell Atlantic NYNEX Mobile)
BellSouth Corporation, Bell Enterprises, Inc., Bellsouth Telecommunications, Inc. (BellSouth)
Bogue, Kansas
Buckeye Cablevision, Inc. (Buckeye Cablevision)

Cable & Wireless, Inc. (Cable & Wireless)
Cellular Telecommunications Industry Association (CTIA)
Celpage, Inc. (Celpage)
Centennial Cellular Corp.
Chrysler Minority Dealers Association (Chrysler Minority Dealers Ass'n)
Cincinnati Bell Telephone Company (Cincinnati Bell)
Citizens Utilities Company (Citizens Utilities)
Classic Telephone, Inc. (Classic Tel.)
Colorado Independent Telephone Association (Colorado Independent Tel. Ass'n)
Colorado Public Utilities Commission (Colorado Commission)
COMAV, Corp. (COMAV)
Comcast Cellular Communications, Inc. (Comcast Cellular)
Comcast Corporation (Comcast)
Communications and Energy Dispute Resolution Associates (CEDRA)
Competition Policy Institute
Competitive Telecommunications Association (CompTel)
Connecticut Department of Public Utility Control (Connecticut Commission)
Consumer Federation of America & Consumers Union (CFA/CU)
Consumer Project on Technology on Interconnection & Unbundling (Consumer Project)
Continental Cablevision, Inc. (Continental)
Cox Communications, Inc. (Cox)
Defense, Secretary of
DeSoto County, Mississippi Economic Development Council
District of Columbia Public Service Commission (District of Columbia Commission)
Economides, Nicholas (N. Economides)
Ericsson Corporation, The (Ericsson)
Excel Telecommunications, Inc. (Excel)
Florida Public Service Commission (Florida Commission)
Fred Williamson & Associates, Inc. (F. Williamson)
Frontier Corporation (Frontier)
General Communication, Inc. (GCI)
General ServicesAdministration/Department of Defense (GSA/DOD)
Georgia Public Service Commission (Georgia Commission)
Greater Washington Urban League
GST Telecom, Inc. (GST)
GTE Service Corporation (GTE)
Guam Telephone Authority
GVNW Inc./Management (GVNW)
Hart Engineers/Robert A. Hart, IV (Hart Engineers)
Hawaii Public Utilities Commission (Hawaii Commission)
Home Telephone Company, Inc. (Home Tel.)
Hyperion Telecommunications, Inc. (Hyperion)
Idaho Public Utilities Commission (Idaho Commission)
Illinois Commerce Commission (Illinois Commission)

Illinois Independent Telephone Association (Illinois Ind. Tel. Ass'n)
Independent Cable & Telecommunications Association (Ind. Cable & Telecomm. Ass'n)
Independent Data Communications Manufacturers Association (IDCMA)
Indiana Utility Regulatory Commission Staff (Indiana Commission Staff)
Information Technology Industry Council (ITIC)
Intelcom Group (U.S.A.), Inc. (Intelcom)
Intermedia Communications, Inc. (Intermedia)
International Communications Association (Intl. Comm. Ass'n)
Iowa Utilities Board (Iowa Commission)
John Staurulakis, Inc. (J. Staurulakis)
Joint Consumer Advocates
Jones Intercable, Inc. (Jones Intercable)
Justice, U. S. Department of (DoJ)
Kansas Corporation Commission (Kansas Commission)
Kentucky Public Service Commission (Kentucky Commission)
Koch, Richard N. (R. Koch)
LCI International Telecom Corp. (LCI)
LDDS Worldcom (LDDS)
Lincoln Telephone & Telegraph Company (Lincoln Tel.)
Louisiana Public Service Commission (Louisiana Commission)
Lucent Technologies, Inc. (Lucent)
Margaretville Telephone Co., Inc. (Margaretville Tel.)
Maryland Public Service Commission (Maryland Commission)
Massachusetts Assistive Technology Partnership Center World Institute on Disability,
Alliance for Technology Access, Trace Research and Development Center, CPB/WGBH
National Center For Accessible Media (Mass. Assistive Tech. Partnership, *et al.*)
Massachusetts, Commonwealth of Department of Public Utilities (Mass. Commission)
Massachusetts, Commonwealth of, Office of Attorney General (Mass. Attorney General)
Matanuska Telephone Association, Inc. (Matanuska Tel.)
MCI
Metricom, Inc. (Metricom)
MFS
Michigan Exchange Carriers Association (MECA)
Michigan, Illinois, and Texas Communities, *et al.*
Michigan Public Service Commission Staff (Michigan Commission Staff)
Minnesota Independent Coalition (Minnesota Independent Coalition)
Minnesota Public Utilities Commission (Minnesota Commission)
Missouri Public Service Commission (Missouri Commission)
Missouri Public Service Commissioner, Harold Crumpton (Missouri Commissioner)
Mobilemedia Communications, Inc. (Mobilemedia)
Motorola Satellite Communications, Inc. and U.S. Leo Services, Inc. (Motorola)
Municipal Utilities
National Association of the Deaf
National Association of Development Organizations, Gray Panthers, United Seniors Health

Cooperative, United Homeowners Association, National Hispanic Council on Aging, National Trust/Trustnet, National Association of Commissions for Women, National Council of Senior Citizens (NADO, *et al.*)
National Association of Regulatory Utility Commissioners (NARUC)
National Association of State Utility Consumer Advocates (National Ass'n of State Utility Advocates)
National Bar Association (National Bar Ass'n)
National Cable Television Association, Inc. (NCTA)
National Exchange Carrier Association, Inc. (NECA)
National League of Cities & National Association of Telecommunications Officers and Advisors (NLC/NATOA)
National Private Telecommunications Association
National Telecommunications & Information Administration (NTIA)
National Wireless Resellers Association (National Wireless Resellers Ass'n)
Nebraska Rural Development Commission
Network Reliability Council, Secretariat of Second (Network Reliability Council)
New Hampshire Public Utilities Commission, New Mexico State Corporation Commission, Utah Division of Public Utilities, Vermont Public Service Board, and Vermont Department of Public Service (New Hampshire Commission, *et al.*)
New Jersey Cable Telecommunications Association, South Carolina Cable Television Association & Texas Cable Telecommunications Association (New Jersey Cable Ass'n, *et al.*)
New Jersey, Staff of Board of Public Utilities (New Jersey Commission Staff)
New York State Consumer Protection Board (New York Consumer Protection Board)
New York State Department of Public Service (New York Commission)
Nextel Communications, Inc. (Nextel)
NEXTLINK Communications, L.L.C. (NEXTLINK)
North Carolina Utility Commission Public Staff (North Carolina Commission Staff)
North Dakota Public Service Commission (North Dakota Commission)
Northern Telecom, Inc. (Nortel)
NYNEX Telephone Companies (NYNEX)
Ohio Public Utilities Commission (Ohio Commission)
Office of the Ohio Consumers' Counsel (Ohio Consumers' Counsel)
Oklahoma Corporation Commission (Oklahoma Commission)
Omnipoint Corporation (Omnipoint)
Optel, Inc. (Optel)
Oregon Public Utility Commission (Oregon Commission)
Pacific Telesis Group (PacTel)
Paging Network, Inc. (PageNet)
Pennsylvania Public Utility Commission (Pennsylvania Commission)
People of the State of California and the Public Utility Commission of the State of California (California Commission)
Personal Communications Industry Association (PCIA)
ProNet Inc. (ProNet)

Puerto Rico Telephone Company (Puerto Rico Tel.)
Roseville Telephone Company (Roseville Tel.)
Rural Telephone Coalition (Rural Tel. Coalition)
SBC Communications Inc. (SBC)
Scherers Communications Group, Inc. (SCG)
Small Business Administration, U.S. (SBA)
Small Cable Business Association (SCBA)
SDN Users Association
South Carolina Public Service Commission (South Carolina Commission)
Southern New England Telephone Company (SNET)
Southwestern Bell Telephone Company (SWBT)
Sprint Corporation (Sprint)
Sprint Spectrum & American Personal Communications (Sprint/APC)
State of Maine Public Utilities Commission, State of Montana Public Service Commission, State of Nebraska Public Service Commission, State of New Hampshire Public Utilities Commission, State of New Mexico State Corporation Commission, State of Utah Public Service Commission and Division of Public Utilities, State of Vermont Department of Public Service and Public Service Board, and Public Utilities Commission of South Dakota (Maine Commission, *et al.*)
TCA, Inc. (TCA)
TDS Telecommunications Corporation (TDS)
Telecommunication Industries Analysis Project
Telecommunications Carriers for Competition (TCC)
Tele-Communications, Inc. (TCI)
Telecommunications Industry Association (TIA)
Telecommunications Ratepayers Association for Cost-Based and Equitable Rates (TRACER)
Telecommunications Resellers Association (Telecomm. Resellers Ass'n)
Telefonica Larga Distancia de Puerto Rico, Inc. (TLD)
Teleport Communications Group, Inc. (Teleport)
Texas Office of Public Utility Counsel (Texas Public Utility Counsel)
Texas, Public Utilities Commission (Texas Commission)
Texas Statewide Telephone Cooperative, Inc.
Texas Telephone Association (Texas Tel. Ass'n)
Time Warner Communications Holdings, Inc. (Time Warner)
Unicom, Inc. (Unicom)
United Calling Network, Inc. (United Calling Network)
United Cerebral Palsy Association
United States Telephone Association (USTA)
USTN Services, Inc. (USTN)
U.S. Network Corporation (U.S. Network)
U S West, Inc. (U S West)
Utah Division of Public Utilities
UTC

Utilex, Inc. (Utilex)
Vanguard Cellular Systems, Inc. (Vanguard)
Vartec Telecom, Inc., Transtel, Telephone Express, CGI, & CommuniGroup Inc. of Mississippi (Vartec, *et al.*)
Virginia State Corporation Commission Staff (Virginia Commission Staff)
Washington Independent Telephone Association (Wash. Ind. Tel. Ass'n)
Washington Utilities and Transportation Commission (Washington Commission)
Western Alliance
WinStar Communications, Inc. (WinStar)
Wisconsin, Public Service Commission (Wisconsin Commission)
Wyoming Public Service Commission (Wyoming Commission)

List Of Commenters in CC Docket No. 95-185

360 Degree Communications Co. (360 Degrees)
AirTouch Communications, Inc. (Airtouch)
Alaska 3 Cellular Corporation (Alaska CellularOne)
Alaska Telephone Association (ATA)
Alliance of Wireless Service Providers (Alliance)
Allied Personal Communications Industry Association of California (Allied)
ALLTEL Corporation (ALLTEL)
American Mobil Telecommunications Association (AMTA)
America's Carriers Telecommunications Association (ACTA)
American Personal Communications/Sprint Spectrum (APC/Sprint)
Ameritech
Anchorage Telephone Utility (ATU)
Arch Communications Group, Inc. (Arch)
AT&T Corporation (AT&T)
Bell Atlantic
Bell Atlantic Nynex Mobile (Bell Atlantic-NYNEX)
BellSouth Corporation (BellSouth)
State of California & the Public Utilities Commission (CPUC)
Cellular Communications of Puerto Rico, Inc. (CCPR)
Cellular Mobile Systems of St. Cloud G.P. (CMS)
Cellular Resellers Association (Cellular Resellers)
Cellular Telecommunications Industry Association (CTIA)
Celpage, Inc. (Celpage)
Centennial Cellular Corporation (Centennial)
Century Cellunet, Inc. (Century Cellunet)
Cincinnati Bell
CMT Partners (CMT)
Comcast Corporation (Comcast)
Competitive Telecommunications Association (CompTel)
Concord Telephone Company (Concord)
Connecticut Department of Public Utility (Connecticut)
Cox Enterprises, Inc. (Cox)
Florida Cellular RSA L.P. (Florida Cellular)
Frontier Corporation (Frontier)
GO Communications Corp. (GO)
General Services Administration (GSA)
GTE Services Corporation (GTE)
GVNW Inc., Management (GVNW)
Hart Engineers and 21st Century Telesis, Inc. (Hart Engineers)
Home Telephone Company, Inc. (HomeTel)
ICO Global Communications (ICO)
Illinois Commerce Commission (Illinois)

Illinois Independent Telephone Association (Illinois Ind. Tel. Assoc.)
Illinois Telephone Association (Illinois Telephone Assoc.)
John Staurulakis, Inc. (JSI)
LDDS WorldCom (LDDS WorldCom)
MCI Telecommunications Corp. (MCI)
MFS Communications Company, Inc. (MFS)
Mercury Cellular & Paging (Mercury)
Mountain Solutions
National Association of Regulatory Utility Commissioners (NARUC)
National Exchange Carrier Association (NECA)
National Telephone Cooperative Association (NTCA)
New Par
New York State Department of Public Service (New York)
Nextel Communications, Inc. (Nextel)
North Carolina 4 Cellular L.P. (North Carolina Cellular)
NYNEX Telephone Companies (NYNEX)
Public Utilities Commission of Ohio (Ohio)
Omnipoint Corporation (Omnipoint)
OPASTCO
Pacific Bell, Pacific Bell Mobile Services, Nevada Bell (Pacific Bell)
Paging Network, Inc. (PageNet)
Personal Communications Industry Association (PCIA)
Point Communications Company (Point)
Poka Lambro Telephone Cooperative (Poka Lambro)
Puerto Rico Telephone Company (PRTC)
Rural Cellular Association (RCA)
Rural Cellular Corporation (RCC)
SBC Communications, Inc. (SBC)
Smithville Telephone Company (Smithville)
Southeast Telephone Company (Southeast Telephone)
Sprint Corporation (Sprint)
Sprint Spectrum and American Personal Communications (Sprint/APC)
Telecommunications Resellers Association (TRA)
Teleport Communications Group (Teleport)
Time Warner Communications Holdings, Inc. (Time Warner)
Telecommunications Ratepayers Association for Cost-Based and Equitable Rates (TRACER)
Union Telephone Company (Union)
United States Telephone Association (USTA)
US West, Inc. (US West)
Vanguard Cellular Systems, Inc. (Vanguard)
Western Radio Services Co., Inc. (Western)
Western Wireless Corporation (Western Wireless)
Westlink Company (Westlink)

List of Commenters in CC Docket No. 91-346

Ad Hoc Telecommunications Users Committee (Ad Hoc)
Allnet Communication Services, Inc. (Allnet)
American Telephone and Telegraph Company (AT&T)
Ameritech Operating Companies (Ameritech)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
Cincinnati Bell Telephone (Cincinnati Bell)
Ericsson Corporation (Ericsson)
General Services Administration (GSA)
Geonet
GTE Service Corporation (GTE)
Information Technology Association of America (ITAA)
Joint Filers (includes Bell Atlantic, BellSouth, GTE, Lincoln, Pacific Bell, Rochester, SNET, and US WEST)
MCI Telecommunications Corporation (MCI)
National Communications System (NCS)
Nextel Communications, Inc. (Nextel)
North American Telecommunications Association (NATA)
Northern Telecom Inc. (Northern Telecom)
NYNEX Telephone Companies (NYNEX)
Pacific Bell and Nevada Bell (Pacific Bell)
Pacific Telesis Corporation (Pactel)
Services-oriented Open Network Technologies, Inc. (SONetech)
Siemens Stromberg-Carlson (Siemens)
Southern New England Telephone Company (SNET)
Southwestern Bell Corporation (SWBT)
Sprint
Telecommunications Industry Association (TIA)
Teleport Communications Group (Teleport)
Teloquent Communications Corporation (Teloquent)
United and Central Telephone Companies (United and Central)
United States Telephone Association (USTA)
US WEST Communications, Inc. (US WEST)

APPENDIX B - Final Rules

AMENDMENTS TO THE CODE OF FEDERAL REGULATIONS

1. Part 1 of Title 47 of the Code of Federal Regulations (C.F.R.) is amended as follows:

PART 1 -- PRACTICE AND PROCEDURE

2. The table of contents of part 1 is revised to read as follows:

* * * * *

Subpart J - Pole Attachment Complaint Procedures

1.1401	**Purpose.**
1.1402	**Definitions.**
1.1403	**Duty to provide access; modifications; notice of removal, increase or modification; petition for temporary stay.**
1.1404	**Complaint.**
1.1405	**File numbers.**
1.1406	**Dismissal of complaints.**
1.1407	**Response and reply.**
1.1408	**Number of copies and form of pleadings.**
1.1409	**Commission consideration of the complaint.**
1.1410	**Remedies.**
1.1411	**Meetings and hearings.**
1.1412	**Enforcement.**
1.1413	**Forfeiture.**
1.1414	**State certification.**
1.1415	**Other orders.**
1.1416	**Imputation of rates; modification costs.**

* * * * *

3. The authority citation for part 1 is revised to read as follows:

AUTHORITY: 47 U.S.C. 151, 154, 251, 252, 303, and 309(j) unless otherwise noted.

4. Section 1.1401 is revised to read as follows:

§ 1.1401 Purpose.

The rules and regulations contained in subpart J of this part provide complaint and enforcement procedures to ensure that telecommunications carriers and cable system operators have nondiscriminatory access to utility poles, ducts, conduits, and rights-of-way on rates, terms,

and conditions that are just and reasonable.

5. Section 1.1402 is amended by revising paragraph (d) to read as follows:

§ 1.1402 Definitions.

* * * * *

(d) The term *complaint* means a filing by a cable television system operator, a cable television system association, a utility, an association of utilities, a telecommunications carrier, or an association of telecommunications carriers alleging that it has been denied access to a utility pole, duct, conduit, or right-of-way in violation of this subpart and/or that a rate, term, or condition for a pole attachment is not just and reasonable.

* * * * *

6. Section 1.1403 is amended by retitling the section, by amending paragraphs (a) and (b) and redesignating them as paragraphs (c) and (d), respectively, and by adding new paragraphs (a) and (b) to read as follows:

§ 1.1403 Duty to provide access; modifications; notice of removal, increase or modification; petition for temporary stay.

(a) A utility shall provide a cable television system or any telecommunications carrier with nondiscriminatory access to any pole, duct, conduit, or right-of-way owned or controlled by it. Notwithstanding this obligation, a utility may deny a cable television system or any telecommunications carrier access to its poles, ducts, conduits, or rights-of-way, on a non-discriminatory basis where there is insufficient capacity or for reasons of safety, reliability and generally applicable engineering purposes.

(b) Requests for access to a utility's poles, ducts, conduits or rights-of-way by a telecommunications carrier or cable operator must be in writing. If access is not granted within 45 days of the request for access, the utility must confirm the denial in writing by the 45th day. The utility's denial of access shall be specific, shall include all relevant evidence and information supporting its denial, and shall explain how such evidence and information relate to a denial of access for reasons of lack of capacity, safety, reliability or engineering standards.

(c) A utility shall provide a cable television system operator or telecommunications carrier no less than 60 days written notice prior to: (1) removal of facilities or termination of any service to those facilities, such removal or termination arising out of a rate, term or condition of the cable television system operator's of telecommunications carrier's pole attachment agreement, or (2) any increase in pole attachment rates; or (3) any modification of facilities other than routine maintenance or modification in response to emergencies.

(d) A cable television system operator or telecommunications carrier may file a

"Petition for Temporary Stay" of the action contained in a notice received pursuant to paragraph (c) of this section within 15 days of receipt of such notice. Such submission shall not be considered unless it includes, in concise terms, the relief sought, the reasons for such relief, including a showing of irreparable harm and likely cessation of cable television service or telecommunication service, a copy of the notice, and certification of service as required by § 1.1404(b) of this subpart. The named respondent may file an answer within 7 days of the date the Petition for Temporary Stay was filed. No further filings under this section will be considered unless requested or authorized by the Commission and no extensions of time will be granted unless justified pursuant to § 1.46.

7. Section 1.1404 is amended by revising paragraphs (b) and (c) and by adding new paragraph (k) to read as follows:

§ 1.1404 Complaint.

* * * * *

(b) The complaint shall be accompanied by a certification of service on the named respondent, and each of the Federal, State, and local governmental agencies that regulate any aspect of the services provided by the complainant or respondent.

(c) In a case where it is claimed that a rate, term, or condition is unjust or unreasonable, the complaint shall contain a statement that the State has not certified to the Commission that it regulates the rates, terms and conditions for pole attachments. The complaint shall include a statement that the utility is not owned by any railroad, any person who is cooperatively organized or any person owned by the Federal Government or any State.

* * * * *

(k) In a case where a cable television system operator or telecommunications carrier claims that it has been denied access to a pole, duct, conduit or right-of-way despite a request made pursuant to section 47 U.S.C. § 224(f), the complaint shall be filed within 30 days of such denial. In addition to meeting the other requirements of this section, the complaint shall include the data and information necessary to support the claim, including:

(1) The reasons given for the denial of access to the utility's poles, ducts, conduits and rights-of-way;

(2) The basis for the complainant's claim that the denial of access is improper;

(3) The remedy sought by the complainant;

(4) A copy of the written request to the utility for access to its poles, ducts, conduits or rights-of-way;

(5) A copy of the utility's response to the written request including all information given by the utility to support its denial of access. A complaint alleging improper denial of access will not be dismissed if the complainant is unable to obtain a utility's written response, or if the utility denies the complainant any other information needed to establish a

prima facie case.

8. Section 1.1409 is amended by revising paragraphs (b) and (d) to read as follows:

§ 1.1409 Commission consideration of the complaint.

* * * * *

(b) The complainant shall have the burden of establishing a *prima facie* case that the rate, term, or condition is not just and reasonable or that the denial of access violates 47 U.S.C. § 224(f). If, however, a utility argues that the proposed rate is lower than its incremental costs, the utility has the burden of establishing that such rate is below the statutory minimum just and reasonable rate. In a case involving a denial of access, the utility shall have the burden of proving that the denial was lawful, once a *prima facie* case is established by the complainant.

* * * * *

(d) The Commission shall deny the complaint if it determines that the complainant has not established a *prima facie* case, or that the rate, term or condition is just and reasonable, or that the denial of access was lawful.

* * * * *

9. Section 1.1416 is amended by retitling the section and by amending paragraph (b) to read as follows:

§ 1.1416 Imputation of rates; modification costs.

* * * * *

(b) The costs of modifying a facility shall be borne by all parties that obtain access to the facility as a result of the modification and by all parties that directly benefit from the modification. Each party described in the preceding sentence shall share proportionately in the cost of the modification. A party with a preexisting attachment to the modified facility shall be deemed to directly benefit from a modification if, after receiving notification of such modification as provided in subpart J of this part, it adds to or modifies its attachment. Notwithstanding the foregoing, a party with a preexisting attachment to a pole, conduit, duct or right-of-way shall not be required to bear any of the costs of rearranging or replacing its attachment if such rearrangement or replacement is necessitated solely as a result of an additional attachment or the modification of an existing attachment sought by another party. If a party makes an attachment to the facility after the completion of the modification, such party shall share proportionately in the cost of the modification if such modification rendered possible the added attachment.

10. Part 20 of Title 47 of the Code of Federal Regulations (C.F.R.) is amended as follows:

PART 20 – COMMERCIAL MOBILE RADIO SERVICES

11. The authority citation for part 20 is revised to read as follows:

AUTHORITY: Secs. 4, 251-2, 303, and 332, 48 Stat. 1066, 1062, as amended; 47 U.S.C. 154, 251-4, 303, and 332 unless otherwise noted.

12. Section 20.11 is amended by adding paragraph (c) to read as follows:

§ 20.11 Interconnection to facilities of local exchange carriers.

* * * * *

(c) Local exchange carriers and commercial mobile radio service providers shall also comply with applicable provisions of part 51 of this chapter.

13. Part 51 of Title 47 of the Code of Federal Regulations (C.F.R.) is added to read as follows:

PART 51 – INTERCONNECTION

Subpart A - General information

Sec.

51.1 Basis and purpose.
51.3 Applicability to negotiated agreements.
51.5 Terms and definitions.

Subpart B - Telecommunications carriers

51.100 General duty.

Subpart C - Obligations of all local exchange carriers

51.201 Resale.
51.203 Number portability.
51.219 Access to rights of way.
51.221 Reciprocal compensation.
51.223 Application of additional requirements.

Subpart D - Additional obligations of incumbent local exchange carriers

51.301 Duty to negotiate.
51.303 Preexisting agreements.
51.305 Interconnection.

51.307 Duty to provide access on an unbundled basis to network elements.
51.309 Use of unbundled network elements.
51.311 Nondiscriminatory access to unbundled network elements.
51.313 Just, reasonable and nondiscriminatory terms and conditions for the provision of unbundled network elements.
51.315 Combination of unbundled network elements.
51.317 Standards for identifying network elements to be made available.
51.319 Specific unbundling requirements.
51.321 Methods of obtaining interconnection and access to unbundled elements under section 251 of the Act.
51.323 Standards for physical collocation and virtual collocation.

Subpart E - Exemptions, suspensions, and modifications of requirements of section251 of the Act.

51.401 State authority.
51.403 Carriers eligible for suspension or modification under section 251(f)(2) of the Act.
51.405 Burden of proof.

Subpart F - Pricing of interconnection and unbundled elements

51.501 Scope.
51.503 General pricing standard.
51.505 Forward-looking economic cost.
51.507 General rate structure standard.
51.509 Rate structure standards for specific elements.
51.511 Forward-looking economic cost per unit.
51.513 Proxies for forward-looking economic cost.
51.515 Application of access charges.

Subpart G - Resale

51.601 Scope of resale rules.
51.603 Resale obligation of all local exchange carriers.
51.605 Additional obligations of incumbent local exchange carriers.
51.607 Wholesale pricing standard.
51.609 Determination of avoided retail costs.
51.611 Interim wholesale rates.
51.613 Restrictions on resale.
51.615 Withdrawal of services.
51.617 Assessment of end user common line charge on resellers.

Subpart H - Reciprocal compensation for transport and termination of local telecommunications traffic

51.701 Scope of transport and termination pricing rules.
51.703 Reciprocal compensation obligation of LECs.
51.705 Incumbent LECs' rates for transport and termination.
51.707 Default proxies for incumbent LECs' transport and termination rates.
51.709 Rate structure for transport and termination.
51.711 Symmetrical reciprocal compensation.
51.713 Bill-and-keep arrangements for reciprocal compensation.
51.715 Interim transport and termination pricing.
51.717 Renegotiation of existing non-reciprocal arrangements.

Subpart I - Procedures for implementation of section 252 of the Act.

51.801 Commission action upon a state commission's failure to act to carry out its responsibility under section 252 of the Act.
51.803 Procedures for Commission notification of a state commission's failure to act.
51.805 The Commission's authority over proceedings and matters.
51.807 Arbitration and mediation of agreements by the Commission pursuant to section 252(e)(5) of the Act.
51.809 Availability of provisions of agreements to other telecommunications carriers under section 252(i) of the Act.

AUTHORITY: Sections 1-5, 7, 201-05, 218, 225-27, 251-54, 271, 48 Stat. 1070, as amended, 1077; 47 U.S.C. 151-55, 157, 201-05, 218, 225-27, 251-54, 271, unless otherwise noted.

Subpart A - General Information.

§ 51.1 Basis and purpose.

(a) *Basis*. These rules are issued pursuant to the Communications Act of 1934, as amended.

(b) *Purpose*. The purpose of these rules is to implement sections 251 and 252 of the Communications Act of 1934, as amended, 47 U.S.C. 251 and 252.

§ 51.3 Applicability to negotiated agreements.

To the extent provided in section 252(e)(2)(A) of the Act, a state commission shall have authority to approve an interconnection agreement adopted by negotiation even if the terms of the agreement do not comply with the requirements of this part.

§ 51.5 Terms and definitions.

Terms used in this part have the following meanings:

Act. The Communications Act of 1934, as amended.

Advanced intelligent network. "Advanced Intelligent Network" is a telecommunications network architecture in which call processing, call routing, and network management are provided by means of centralized databases located at points in an incumbent local exchange carrier's network.

Arbitration, final offer. "Final offer arbitration" is a procedure under which each party submits a final offer concerning the issues subject to arbitration, and the arbitrator selects, without modification, one of the final offers by the parties to the arbitration or portions of both such offers. "Entire package final offer arbitration," is a procedure under which the arbitrator must select, without modification, the entire proposal submitted by one of the parties to the arbitration. "Issue-by-issue final offer arbitration," is a procedure under which the arbitrator must select, without modification, on an issue-by-issue basis, one of the proposals submitted by the parties to the arbitration.

Billing. "Billing" involves the provision of appropriate usage data by one telecommunications carrier to another to facilitate customer billing with attendant acknowledgements and status reports. It also involves the exchange of information between telecommunications carriers to process claims and adjustments.

Commercial Mobile Radio Service (CMRS). "CMRS" has the same meaning as that term is defined in § 20.3 of this chapter.

Commission. "Commission" refers to the Federal Communications Commission.

Directory assistance service. "Directory assistance service" includes, but is not limited to, making available to customers, upon request, information contained in directory listings.

Directory listings. "Directory listings" are any information: (1) identifying the listed names of subscribers of a telecommunications carrier and such subscriber's telephone numbers, addresses, or primary advertising classifications (as such classifications are assigned at the time of the establishment of such service), or any combination of such listed names, numbers, addresses or classifications; and (2) that the telecommunications carrier or an affiliate has published, caused to be published, or accepted for publication in any directory format.

Downstream database. A "downstream database" is a database owned and operated by an individual carrier for the purpose of providing number portability in conjunction with other functions and services.

Equipment necessary for interconnection or access to unbundled network elements. For

purposes of section 251(c)(2) of the Act, the equipment used to interconnect with an incumbent local exchange carrier's network for the transmission and routing of telephone exchange service, exchange access service, or both. For the purposes of section 251(c)(3) of the Act, the equipment used to gain access to an incumbent local exchange carrier's unbundled network elements for the provision of a telecommunications service.

Incumbent Local Exchange Carrier (Incumbent LEC). With respect to an area, the local exchange carrier that: (1) on February 8, 1996, provided telephone exchange service in such area; and (2) (i) on February 8, 1996, was deemed to be a member of the exchange carrier association pursuant to § 69.601(b) of this chapter; or (ii) is a person or entity that, on or after February 8, 1996, became a successor or assign of a member described in clause (i) of this paragraph.

Interconnection. "Interconnection" is the linking of two networks for the mutual exchange of traffic. This term does not include the transport and termination of traffic.

Local Exchange Carrier (LEC). A "LEC" is any person that is engaged in the provision of telephone exchange service or exchange access. Such term does not include a person insofar as such person is engaged in the provision of a commercial mobile service under section 332(c) of the Act, except to the extent that the Commission finds that such service should be included in the definition of the such term.

Maintenance and repair. "Maintenance and repair" involves the exchange of information between telecommunications carriers where one initiates a request for maintenance or repair of existing products and services or unbundled network elements or combination thereof from the other with attendant acknowledgements and status reports.

Meet point. A "meet point" is a point of interconnection between two networks, designated by two telecommunications carriers, at which one carrier's responsibility for service begins and the other carrier's responsibility ends.

Meet point interconnection arrangement. A "meet point interconnection arrangement" is an arrangement by which each telecommunications carrier builds and maintains its network to a meet point.

Network element. A "network element" is a facility or equipment used in the provision of a telecommunications service. Such term also includes, but is not limited to, features, functions, and capabilities that are provided by means of such facility or equipment, including but not limited to, subscriber numbers, databases, signaling systems, and information sufficient for billing and collection or used in the transmission, routing, or other provision of a telecommunications service.

Operator services. "Operator services" are any automatic or live assistance to a consumer to arrange for billing or completion of a telephone call. Such services include, but are not limited to, busy line verification, emergency interrupt, and operator-assisted directory assistance services.

Physical collocation. "Physical collocation" is an offering by an incumbent LEC that enables a requesting telecommunications carrier to:

(1) place its own equipment to be used for interconnection or access to unbundled network elements within or upon an incumbent LEC's premises;

(2) use such equipment to interconnect with an incumbent LEC's network facilities for the transmission and routing of telephone exchange service, exchange access service, or both, or to gain access to an incumbent LEC's unbundled network elements for the provision of a telecommunications service;

(3) enter those premises, subject to reasonable terms and conditions, to install, maintain, and repair equipment necessary for interconnection or access to unbundled elements; and

(4) obtain reasonable amounts of space in an incumbent LEC's premises, as provided in this part, for the equipment necessary for interconnection or access to unbundled elements, allocated on a first-come, first-served basis.

Premises. "Premises" refers to an incumbent LEC's central offices and serving wire centers, as well as all buildings or similar structures owned or leased by an incumbent LEC that house its network facilities, and all structures that house incumbent LEC facilities on public rights-of-way, including but not limited to vaults containing loop concentrators or similar structures.

Pre-ordering and ordering. "Pre-ordering and ordering" includes the exchange of information between telecommunications carriers about current or proposed customer products and services or unbundled network elements or some combination thereof.

Provisioning. "Provisioning" involves the exchange of information between telecommunications carriers where one executes a request for a set of products and services or unbundled network elements or combination thereof from the other with attendant acknowledgements and status reports.

Rural telephone company. A "rural telephone company" is a LEC operating entity to the extent that such entity:

(1) provides common carrier service to any local exchange carrier study area that does not include either:

(i) any incorporated place of 10,000 inhabitants or more, or any part thereof, based on the most recently available population statistics of the Bureau of the Census; or

(ii) any territory, incorporated or unincorporated, included in an urbanized area, as defined by the Bureau of the Census as of August 10, 1993;

(2) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines;

(3) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or

(4) has less than 15 percent of its access lines in communities of more than 50,000

on February 8, 1996.

Service control point. A "service control point" is a computer database in the public switched network which contains information and call processing instructions needed to process and complete a telephone call.

Service creation environment. A "service creation environment" is a computer containing generic call processing software that can be programmed to create new advanced intelligent network call processing services.

Signal transfer point. A "signal transfer point" is a packet switch that acts as a routing hub for a signaling network and transfers messages between various points in and among signaling networks.

State commission. A "state commission" means the commission, board, or official (by whatever name designated) which under the laws of any State has regulatory jurisdiction with respect to intrastate operations of carriers. As referenced in this part, this term may include the Commission if it assumes the responsibility of the state commission, pursuant to section 252(e)(5) of the Act. This term shall also include any person or persons to whom the state commission has delegated its authority under section 251 and 252 of the Act.

State proceeding. A "state proceeding" is any administrative proceeding in which a state commission may approve or prescribe rates, terms, and conditions including, but not limited to, compulsory arbitration pursuant to section 252(b) of the Act, review of a Bell operating company statement of generally available terms pursuant section 252(f) of the Act, and a proceeding to determine whether to approve or reject an agreement adopted by arbitration pursuant to section 252(e) of the Act.

Technically feasible. Interconnection, access to unbundled network elements, collocation, and other methods of achieving interconnection or access to unbundled network elements at a point in the network shall be deemed technically feasible absent technical or operational concerns that prevent the fulfillment of a request by a telecommunications carrier for such interconnection, access, or methods. A determination of technical feasibility does not include consideration of economic, accounting, billing, space, or site concerns, except that space and site concerns may be considered in circumstances where there is no possibility of expanding the space available. The fact that an incumbent LEC must modify its facilities or equipment to respond to such request does not determine whether satisfying such request is technically feasible. An incumbent LEC that claims that it cannot satisfy such request because of adverse network reliability impacts must prove to the state commission by clear and convincing evidence that such interconnection, access, or methods would result in specific and significant adverse network reliability impacts.

Telecommunications carrier. A "telecommunications carrier" is any provider of telecommunications services, except that such term does not include aggregators of telecommunications services (as defined in section 226 of the Act). A telecommunications carrier shall be treated as a common carrier under the Act only to the extent that it is engaged in

providing telecommunications services, except that the Commission shall determine whether the provision of fixed and mobile satellite service shall be treated as common carriage. This definition includes CMRS providers, interexchange carriers (IXCs) and, to the extent they are acting as telecommunications carriers, companies that provide both telecommunications and information services. Private Mobile Radio Service providers are telecommunications carriers to the extent they provide domestic or international telecommunications for a fee directly to the public.

Virtual collocation. "Virtual collocation" is an offering by an incumbent LEC that enables a requesting telecommunications carrier to:

(1) designate or specify equipment to be used for interconnection or access to unbundled network elements to be located within or upon an incumbent LEC's premises, and dedicated to such telecommunications carrier's use;

(2) use such equipment to interconnect with an incumbent LEC's network facilities for the transmission and routing of telephone exchange service, exchange access service, or both, or for access to an incumbent LEC's unbundled network elements for the provision of a telecommunications service; and

(3) electronically monitor and control its communications channels terminating in such equipment.

Subpart B - Telecommunications Carriers.

§ 51.100 General duty.

(a) Each telecommunications carrier has the duty:

(1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and

(2) to not install network features, functions, or capabilities that do not comply with the guidelines and standards as provided in the Commission's rules or section 255 or 256 of the Act.

(b) A telecommunication carrier that has interconnected or gained access under sections 251(a)(1), 251(c)(2), or 251(c)(3) of the Act, may offer information services through the same arrangement, so long as it is offering telecommunications services through the same arrangement as well.

Subpart C - Obligations of All Local Exchange Carriers.

§ 51.201 Resale.

The rules governing resale of services by an incumbent LEC are set forth in subpart G of this part.

§ 51.203 Number portability.

The rules governing number portability are set forth in part 52, subpart C of this chapter.

§ 51.219 Access to rights of way.

The rules governing access to rights of way are set forth in part 1, subpart J of this chapter.

§ 51.221 Reciprocal compensation.

The rules governing reciprocal compensation are set forth in subpart H of this part.

§ 51.223 Application of additional requirements.

(a) A state may not impose the obligations set forth in section 251(c) of the Act on a LEC that is not classified as an incumbent LEC as defined in section 251(h)(1) of the Act, unless the Commission issues an order declaring that such LECs or classes or categories of LECs should be treated as incumbent LECs.

(b) A state commission, or any other interested party, may request that the Commission issue an order declaring that a particular LEC be treated as an incumbent LEC, or that a class or category of LECs be treated as incumbent LECs, pursuant to section 251(h)(2) of the Act.

Subpart D - Additional Obligations of Incumbent Local Exchange Carriers.

§ 51.301 Duty to negotiate.

(a) An incumbent LEC shall negotiate in good faith the terms and conditions of agreements to fulfill the duties established by sections 251(b) and (c) of the Act.

(b) A requesting telecommunications carrier shall negotiate in good faith the terms and conditions of agreements described in paragraph (a) of this section.

(c) If proven to the Commission, an appropriate state commission, or a court of competent jurisdiction, the following actions or practices, among others, violate the duty to negotiate in good faith:

(1) demanding that another party sign a nondisclosure agreement that precludes such party from providing information requested by the Commission, or a state commission, or in support of a request for arbitration under section 252(b)(2)(B) of the Act;

(3) refusing to include in an arbitrated or negotiated agreement a provision that permits the agreement to be amended in the future to take into account changes in Commission or state rules;

(4) conditioning negotiation on a requesting telecommunications carrier first obtaining state certifications;

(5) intentionally misleading or coercing another party into reaching an agreement that it would not otherwise have made;

(6) intentionally obstructing or delaying negotiations or resolutions of disputes;

(7) refusing throughout the negotiation process to designate a representative with authority to make binding representations, if such refusal significantly delays resolution of issues; and

(8) refusing to provide information necessary to reach agreement. Such refusal includes, but is not limited to:

(i) refusal by an incumbent LEC to furnish information about its network that a requesting telecommunications carrier reasonably requires to identify the network elements that it needs in order to serve a particular customer; and

(ii) refusal by a requesting telecommunications carrier to furnish cost data that would be relevant to setting rates if the parties were in arbitration.

§ 51.303 Preexisting agreements.

(a) All interconnection agreements between an incumbent LEC and a telecommunications carrier, including those negotiated before February 8, 1996, shall be submitted by the parties to the appropriate state commission for approval pursuant to section 252(e) of the Act.

(b) Interconnection agreements negotiated before February 8, 1996, between Class A carriers, as defined by § 32.11(a)(1) of this chapter, shall be filed by the parties with the appropriate state commission no later than June 30, 1997, or such earlier date as the state commission may require.

(c) If a state commission approves a preexisting agreement, it shall be made available to other parties in accordance with section 252(i) of the Act and § 51.809 of this part. A state commission may reject a preexisting agreement on the grounds that it is inconsistent with the public interest, or for other reasons set forth in section 252(e)(2)(A) of the Act.

§ 51.305 Interconnection.

(a) An incumbent LEC shall provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the incumbent LEC's network:

(1) for the transmission and routing of telephone exchange traffic, exchange access traffic, or both;

(2) at any technically feasible point within the incumbent LEC's network including, at a minimum:

(i) the line-side of a local switch;
(ii) the trunk-side of a local switch;
(iii) the trunk interconnection points for a tandem switch;
(iv) central office cross-connect points;
(v) out-of-band signaling transfer points necessary to exchange traffic at these points and access call-related databases; and
(vi) the points of access to unbundled network elements as described in § 51.319 of this part;

(3) that is at a level of quality that is equal to that which the incumbent LEC provides itself, a subsidiary, an affiliate, or any other party, except as provided in paragraph (4) of this section. At a minimum, this requires an incumbent LEC to design interconnection facilities to meet the same technical criteria and service standards that are used within the incumbent LEC's network. This obligation is not limited to a consideration of service quality as perceived by end users, and includes, but is not limited to, service quality as perceived by the requesting telecommunications carrier;

(4) that, if so requested by a telecommunications carrier and to the extent technically feasible, is superior in quality to that provided by the incumbent LEC to itself or to any subsidiary, affiliate, or any other party to which the incumbent LEC provides interconnection. Nothing in this section prohibits an incumbent LEC from providing interconnection that is lesser in quality at the sole request of the requesting telecommunications carrier; and

(5) on terms and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of any agreement, the requirements of sections 251 and 252 of the Act, and the Commission's rules including, but not limited to, offering such terms and conditions equally to all requesting telecommunications carriers, and offering such terms and conditions that are no less favorable than the terms and conditions upon which the incumbent LEC provides such interconnection to itself. This includes, but is not limited to, the time within which the incumbent LEC provides such interconnection.

(b) A carrier that requests interconnection solely for the purpose of originating or terminating its interexchange traffic on an incumbent LEC's network and not for the purpose of providing to others telephone exchange service, exchange access service, or both, is not entitled to receive interconnection pursuant to section 251(c)(2) of the Act.

(c) Previous successful interconnection at a particular point in a network, using particular facilities, constitutes substantial evidence that interconnection is technically feasible at that point, or at substantially similar points, in networks employing substantially similar

facilities. Adherence to the same interface or protocol standards shall constitute evidence of the substantial similarity of network facilities.

(d) Previous successful interconnection at a particular point in a network at a particular level of quality constitutes substantial evidence that interconnection is technically feasible at that point, or at substantially similar points, at that level of quality.

(e) An incumbent LEC that denies a request for interconnection at a particular point must prove to the state commission that interconnection at that point is not technically feasible.

(f) If technically feasible, an incumbent LEC shall provide two-way trunking upon request.

§ 51.307 Duty to provide access on an unbundled basis to network elements.

(a) An incumbent LEC shall provide, to a requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on terms and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of any agreement, the requirements of sections 251 and 252 of the Act, and the Commission's rules.

(b) The duty to provide access to unbundled network elements pursuant to section 251(c)(3) of the Act includes a duty to provide a connection to an unbundled network element independent of any duty to provide interconnection pursuant to this part and section 251(c)(2) of the Act.

(c) An incumbent LEC shall provide a requesting telecommunications carrier access to an unbundled network element, along with all of the unbundled network element's features, functions, and capabilities, in a manner that allows the requesting telecommunications carrier to provide any telecommunications service that can be offered by means of that network element.

(d) An incumbent LEC shall provide a requesting telecommunications carrier access to the facility or functionality of a requested network element separate from access to the facility or functionality of other network elements, for a separate charge.

§ 51.309 Use of unbundled network elements.

(a) An incumbent LEC shall not impose limitations, restrictions, or requirements on requests for, or the use of, unbundled network elements that would impair the ability of a requesting telecommunications carrier to offer a telecommunications service in the manner the requesting telecommunications carrier intends.

(b) A telecommunications carrier purchasing access to an unbundled network element may use such network element to provide exchange access services to itself in order to provide

interexchange services to subscribers.

(c) A telecommunications carrier purchasing access to an unbundled network facility is entitled to exclusive use of that facility for a period of time, or when purchasing access to a feature, function, or capability of a facility, a telecommunications carrier is entitled to use of that feature, function, or capability for a period of time. A telecommunications carrier's purchase of access to an unbundled network element does not relieve the incumbent LEC of the duty to maintain, repair, or replace the unbundled network element.

§ 51.311 Nondiscriminatory access to unbundled network elements.

(a) The quality of an unbundled network element, as well as the quality of the access to the unbundled network element, that an incumbent LEC provides to a requesting telecommunications carrier shall be the same for all telecommunications carriers requesting access to that network element, except as provided in paragraph (c) of this section.

(b) Except as provided in paragraph (c) of this section, to the extent technically feasible, the quality of an unbundled network element, as well as the quality of the access to such unbundled network element, that an incumbent LEC provides to a requesting telecommunications carrier shall be at least equal in quality to that which the incumbent LEC provides to itself. If an incumbent LEC fails to meet this requirement, the incumbent LEC must prove to the state commission that it is not technically feasible to provide the requested unbundled network element, or to provide access to the requested unbundled network element, at a level of quality that is equal to that which the incumbent LEC provides to itself.

(c) To the extent technically feasible, the quality of an unbundled network element, as well as the quality of the access to such unbundled network element, that an incumbent LEC provides to a requesting telecommunications carrier shall, upon request, be superior in quality to that which the incumbent LEC provides to itself. If an incumbent LEC fails to meet this requirement, the incumbent LEC must prove to the state commission that it is not technically feasible to provide the requested unbundled network element or access to such unbundled network element at the requested level of quality that is superior to that which the incumbent LEC provides to itself. Nothing in this section prohibits an incumbent LEC from providing interconnection that is lesser in quality at the sole request of the requesting telecommunications carrier.

(d) Previous successful access to an unbundled element at a particular point in a network, using particular facilities, is substantial evidence that access is technically feasible at that point, or at substantially similar points, in networks employing substantially similar facilities. Adherence to the same interface or protocol standards shall constitute evidence of the substantial similarity of network facilities.

(e) Previous successful provision of access to an unbundled element at a particular point in a network at a particular level of quality is substantial evidence that access is technically feasible at that point, or at substantially similar points, at that level of quality.

§ 51.313 Just, reasonable and nondiscriminatory terms and conditions for the provision of unbundled network elements.

(a) The terms and conditions pursuant to which an incumbent LEC provides access to unbundled network elements shall be offered equally to all requesting telecommunications carriers.

(b) Where applicable, the terms and conditions pursuant to which an incumbent LEC offers to provide access to unbundled network elements, including but not limited to, the time within which the incumbent LEC provisions such access to unbundled network elements, shall, at a minimum, be no less favorable to the requesting carrier than the terms and conditions under which the incumbent LEC provides such elements to itself.

(c) An incumbent LEC must provide a carrier purchasing access to unbundled network elements with the pre-ordering, ordering, provisioning, maintenance and repair, and billing functions of the incumbent LEC's operations support systems.

§ 51.315 Combination of unbundled network elements.

(a) An incumbent LEC shall provide unbundled network elements in a manner that allows requesting telecommunications carriers to combine such network elements in order to provide a telecommunications service.

(b) Except upon request, an incumbent LEC shall not separate requested network elements that the incumbent LEC currently combines.

(c) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network, provided that such combination is:

(1) technically feasible; and

(2) would not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.

(d) Upon request, an incumbent LEC shall perform the functions necessary to combine unbundled network elements with elements possessed by the requesting telecommunications carrier in any technically feasible manner.

(e) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(1) or paragraph (d) of this section must prove to the state commission that the requested combination is not technically feasible.

(f) An incumbent LEC that denies a request to combine elements pursuant to paragraph (c)(2) of this section must prove to the state commission that the requested combination would impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network.

§ 51.317 Standards for identifying network elements to be made available.

(a) In determining what network elements should be made available for purposes of section 251(c)(3) of the Act beyond those identified in § 51.319 of this part, a state commission shall first determine whether it is technically feasible for the incumbent LEC to provide access to a network element on an unbundled basis.

(b) If the state commission determines that it is technically feasible for the incumbent LEC to provide access to the network element on an unbundled basis, the state commission may decline to require unbundling of the network element only if:

(1) the state commission concludes that:

(i) the network element is proprietary, or contains proprietary information that will be revealed if the network element is provided on an unbundled basis; and

(ii) a requesting telecommunications carrier could offer the same proposed telecommunications service through the use of other, nonproprietary unbundled network elements within the incumbent LEC's network; or

(2) the state commission concludes that the failure of the incumbent LEC to provide access to the network element would not decrease the quality of, and would not increase the financial or administrative cost of, the telecommunications service a requesting telecommunications carrier seeks to offer, compared with providing that service over other unbundled network elements in the incumbent LEC's network.

§ 51.319 Specific unbundling requirements.

An incumbent LEC shall provide nondiscriminatory access in accordance with § 51.311 of this part and section 251(c)(3) of the Act to the following network elements on an unbundled basis to any requesting telecommunications carrier for the provision of a telecommunications service:

(a) *Local Loop*. The local loop network element is defined as a transmission facility between a distribution frame (or its equivalent) in an incumbent LEC central office and an end user customer premises;

(b) *Network Interface Device*.

(1) The network interface device network element is defined as a cross-connect device used to connect loop facilities to inside wiring.

(2) An incumbent LEC shall permit a requesting telecommunications carrier to connect its own local loops to the inside wiring of premises through the incumbent LEC's network interface device. The requesting telecommunications carrier shall establish this connection through an adjoining network interface device deployed by such telecommunications carrier;

(c) *Switching Capability*.

(1) Local Switching Capability.

(i) The local switching capability network element is defined as:

(A) line-side facilities, which include, but are not limited to, the connection between a loop termination at a main distribution frame and a switch line card;

(B) trunk-side facilities, which include, but are not limited to, the connection between trunk termination at a trunk-side cross-connect panel and a switch trunk card; and

(C) all features, functions, and capabilities of the switch, which include, but are not limited to:

(*1*) the basic switching function of connecting lines to lines, lines to trunks, trunks to lines, and trunks to trunks, as well as the same basic capabilities made available to the incumbent LEC's customers, such as a telephone number, white page listing, and dial tone; and

(*2*) all other features that the switch is capable of providing, including but not limited to custom calling, custom local area signaling service features, and Centrex, as well as any technically feasible customized routing functions provided by the switch.

(ii) An incumbent LEC shall transfer a customer's local service to a competing carrier within a time period no greater than the interval within which the incumbent LEC currently transfers end users between interexchange carriers, if such transfer requires only a change in the incumbent LEC's software;

(2) Tandem Switching Capability. The tandem switching capability network element is defined as:

(i) trunk-connect facilities, including but not limited to the connection between trunk termination at a cross-connect panel and a switch trunk card;

(ii) the basic switching function of connecting trunks to trunks; and

(iii) the functions that are centralized in tandem switches (as distinguished from separate end-office switches), including but not limited to call recording, the routing of calls to operator services, and signaling conversion features;

(d) *Interoffice Transmission Facilities*.

(1) Interoffice transmission facilities are defined as incumbent LEC transmission facilities dedicated to a particular customer or carrier, or shared by more than one customer or carrier, that provide telecommunications between wire centers owned by incumbent LECs or

requesting telecommunications carriers, or between switches owned by incumbent LECs or requesting telecommunications carriers.

(2) The incumbent LEC shall:

(i) provide a requesting telecommunications carrier exclusive use of interoffice transmission facilities dedicated to a particular customer or carrier, or use of the features, functions, and capabilities of interoffice transmission facilities shared by more than one customer or carrier;

(ii) provide all technically feasible transmission facilities, features, functions, and capabilities that the requesting telecommunications carrier could use to provide telecommunications services;

(iii) permit, to the extent technically feasible, a requesting telecommunications carrier to connect such interoffice facilities to equipment designated by the requesting telecommunications carrier, including, but not limited to, the requesting telecommunications carrier's collocated facilities; and

(iv) permit, to the extent technically feasible, a requesting telecommunications carrier to obtain the functionality provided by the incumbent LEC's digital cross-connect systems in the same manner that the incumbent LEC provides such functionality to interexchange carriers;

(e) *Signaling Networks and Call-Related Databases*.

(1) Signaling Networks.

(i) Signaling networks include, but are not limited to, signaling links and signaling transfer points.

(ii) When a requesting telecommunications carrier purchases unbundled switching capability from an incumbent LEC, the incumbent LEC shall provide access to its signaling network from that switch in the same manner in which it obtains such access itself.

(iii) An incumbent LEC shall provide a requesting telecommunications carrier with its own switching facilities access to the incumbent LEC's signaling network for each of the requesting telecommunications carrier's switches. This connection shall be made in the same manner as an incumbent LEC connects one of its own switches to a signal transfer point.

(iv) Under this paragraph, an incumbent LEC is not required to unbundle those signaling links that connect service control points to switching transfer points or to permit a requesting telecommunications carrier to link its own signal transfer points directly to the incumbent LEC's switch or call-related databases;

(2) Call-Related Databases.

(i) Call-related databases are defined as databases, other than operations support systems, that are used in signaling networks for billing and collection or the transmission, routing, or other provision of a telecommunications service.

(ii) For purposes of switch query and database response through a signaling network, an incumbent LEC shall provide access to its call-related databases, including, but not limited to, the Line Information Database, Toll Free Calling database, downstream number portability databases, and Advanced Intelligent Network databases, by means of physical access at the signaling transfer point linked to the unbundled database.

(iii) An incumbent LEC shall allow a requesting telecommunications carrier that has purchased an incumbent LEC's local switching capability to use the incumbent LEC's service control point element in the same manner, and via the same signaling links, as the incumbent LEC itself.

(iv) An incumbent LEC shall allow a requesting telecommunications carrier that has deployed its own switch, and has linked that switch to an incumbent LEC's signaling system, to gain access to the incumbent LEC's service control point in a manner that allows the requesting carrier to provide any call-related, database-supported services to customers served by the requesting telecommunications carrier's switch.

(v) A state commission shall consider whether mechanisms mediating access to an incumbent LEC's Advanced Intelligent Network service control points are necessary, and if so, whether they will adequately safeguard against intentional or unintentional misuse of the incumbent LEC's Advanced Intelligent Network facilities.

(vi) An incumbent LEC shall provide a requesting telecommunications carrier with access to call-related databases in a manner that complies with section 222 of the Act;

(3) Service Management Systems.

(A) A service management system is defined as a computer database or system not part of the public switched network that, among other things:

(*1*) interconnects to the service control point and sends to that service control point the information and call processing instructions needed for a network switch to process and complete a telephone call; and

(*2*) provides telecommunications carriers with the capability of entering and storing data regarding the processing and completing of a telephone call.

(B) An incumbent LEC shall provide a requesting telecommunications carrier with the information necessary to enter correctly, or format for entry, the information relevant for input into the particular incumbent LEC service management system.

(C) An incumbent LEC shall provide a requesting telecommunications carrier the same access to design, create, test, and deploy Advanced Intelligent Network-based services at the service management system, through a service creation environment, that the incumbent LEC provides to itself.

(D) A state commission shall consider whether mechanisms mediating access to Advanced Intelligent Network service management systems and service creation environments are necessary, and if so, whether they will adequately safeguard against intentional or unintentional misuse of the incumbent LEC's Advanced Intelligent Network facilities.

(E) An incumbent LEC shall provide a requesting telecommunications carrier access to service management systems in a manner that complies with section 222 of the Act;

(f) *Operations Support Systems Functions*.

(1) Operations support systems functions consist of pre-ordering, ordering, provisioning, maintenance and repair, and billing functions supported by an incumbent LEC's databases and information.

(2) An incumbent LEC that does not currently comply with this requirement shall do so as expeditiously as possible, but, in any event, no later than January 1, 1997; and

(g) *Operator Services and Directory Assistance*. An incumbent LEC shall provide access to operator service and directory assistance facilities where technically feasible.

§ 51.321 Methods of obtaining interconnection and access to unbundled elements under section 251 of the Act.

(a) Except as provided in paragraph (e) of this section, an incumbent LEC shall provide, on terms and conditions that are just, reasonable, and nondiscriminatory in accordance with the requirements of this part, any technically feasible method of obtaining interconnection or access to unbundled network elements at a particular point upon a request by a telecommunications carrier.

(b) Technically feasible methods of obtaining interconnection or access to unbundled network elements include, but are not limited to:

(1) physical collocation and virtual collocation at the premises of an incumbent LEC; and

(2) meet point interconnection arrangements.

(c) A previously successful method of obtaining interconnection or access to unbundled network elements at a particular premises or point on an incumbent LEC's network is substantial evidence that such method is technically feasible in the case of substantially similar network premises or points.

(d) An incumbent LEC that denies a request for a particular method of obtaining interconnection or access to unbundled network elements on the incumbent LEC's network must prove to the state commission that the requested method of obtaining interconnection or access to unbundled network elements at that point is not technically feasible.

(e) An incumbent LEC shall not be required to provide for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the incumbent LEC's premises if it demonstrates to the state commission that physical collocation is not practical for technical reasons or because of space limitations. In such cases, the incumbent LEC shall be required to provide virtual collocation, except at points where the incumbent LEC proves to the state commission that virtual collocation is not technically feasible. If virtual collocation is not technically feasible, the incumbent LEC shall provide other methods of interconnection and access to unbundled network elements to the extent technically feasible.

(f) An incumbent LEC shall submit to the state commission detailed floor plans or diagrams of any premises where the incumbent LEC claims that physical collocation is not practical because of space limitations.

(g) An incumbent LEC that is classified as a Class A company under § 32.11 of this chapter and that is not a National Exchange Carrier Association interstate tariff participant as provided in part 69, subpart G, shall continue to provide expanded interconnection service pursuant to interstate tariff in accordance with §§ 64.1401, 64.1402, 69.121 of this chapter, and the Commission's other requirements.

§ 51.323 Standards for physical collocation and virtual collocation.

(a) An incumbent LEC shall provide physical collocation and virtual collocation to requesting telecommunications carriers.

(b) An incumbent LEC shall permit the collocation of any type of equipment used for interconnection or access to unbundled network elements. Whenever an incumbent LEC objects to collocation of equipment by a requesting telecommunications carrier for purposes within the scope of section 251(c)(6) of the Act, the incumbent LEC shall prove to the state commission that the equipment will not be actually used by the telecommunications carrier for the purpose of obtaining interconnection or access to unbundled network elements. Equipment used for interconnection and access to unbundled network elements includes, but is not limited to:

(1) transmission equipment including, but not limited to, optical terminating equipment and multiplexers; and

(2) equipment being collocated to terminate basic transmission facilities pursuant to §§ 64.1401 and 64.1402 of this chapter as of August 1, 1996.

(c) Nothing in this section requires an incumbent LEC to permit collocation of switching equipment or equipment used to provide enhanced services.

(d) When an incumbent LEC provides physical collocation, virtual collocation, or both,

the incumbent LEC shall:

(1) provide an interconnection point or points, physically accessible by both the incumbent LEC and the collocating telecommunications carrier, at which the fiber optic cable carrying an interconnector's circuits can enter the incumbent LEC's premises, provided that the incumbent LEC shall designate interconnection points as close as reasonably possible to its premises;

(2) provide at least two such interconnection points at each incumbent LEC premises at which there are at least two entry points for the incumbent LEC's cable facilities, and at which space is available for new facilities in at least two of those entry points;

(3) permit interconnection of copper or coaxial cable if such interconnection is first approved by the state commission; and

(4) permit physical collocation of microwave transmission facilities except where such collocation is not practical for technical reasons or because of space limitations, in which case virtual collocation of such facilities is required where technically feasible.

(e) When providing virtual collocation, an incumbent LEC shall, at a minimum, install, maintain, and repair collocated equipment identified in paragraph (b) of this section within the same time periods and with failure rates that are no greater than those that apply to the performance of similar functions for comparable equipment of the incumbent LEC itself.

(f) An incumbent LEC shall allocate space for the collocation of the equipment identified in paragraph (b) of this section in accordance with the following requirements:

(1) an incumbent LEC shall make space available within or on its premises to requesting telecommunications carriers on a first-come, first-served basis, provided, however, that the incumbent LEC shall not be required to lease or construct additional space to provide for physical collocation when existing space has been exhausted;

(2) to the extent possible, an incumbent LEC shall make contiguous space available to requesting telecommunications carriers that seek to expand their existing collocation space;

(3) when planning renovations of existing facilities or constructing or leasing new facilities, an incumbent LEC shall take into account projected demand for collocation of equipment;

(4) an incumbent LEC may retain a limited amount of floor space for its own specific future uses, provided, however, that the incumbent LEC may not reserve space for future use on terms more favorable than those that apply to other telecommunications carriers seeking to reserve collocation space for their own future use;

(5) an incumbent LEC shall relinquish any space held for future use before denying a request for virtual collocation on the grounds of space limitations, unless the incumbent LEC proves to the state commission that virtual collocation at that point is not technically feasible; and

(6) an incumbent LEC may impose reasonable restrictions on the warehousing of unused space by collocating telecommunications carriers, provided, however, that the incumbent LEC shall not set maximum space limitations applicable to such carriers unless the incumbent LEC proves to the state commission that space constraints make such restrictions necessary.

(g) An incumbent LEC shall permit collocating telecommunications carriers to collocate equipment and connect such equipment to unbundled network transmission elements obtained from the incumbent LEC, and shall not require such telecommunications carriers to bring their own transmission facilities to the incumbent LEC's premises in which they seek to collocate equipment.

(h) An incumbent LEC shall permit a collocating telecommunications carrier to interconnect its network with that of another collocating telecommunications carrier at the incumbent LEC's premises and to connect its collocated equipment to the collocated equipment of another telecommunications carrier within the same premises provided that the collocated equipment is also used for interconnection with the incumbent LEC or for access to the incumbent LEC's unbundled network elements.

(1) An incumbent LEC shall provide the connection between the equipment in the collocated spaces of two or more telecommunications carriers, unless the incumbent LEC permits one or more of the collocating parties to provide this connection for themselves; and

(2) An incumbent LEC is not required to permit collocating telecommunications carriers to place their own connecting transmission facilities within the incumbent LEC's premises outside of the actual physical collocation space.

(i) An incumbent LEC may require reasonable security arrangements to separate a collocating telecommunications carrier's space from the incumbent LEC's facilities.

(j) An incumbent LEC shall permit a collocating telecommunications carrier to subcontract the construction of physical collocation arrangements with contractors approved by the incumbent LEC, provided, however, that the incumbent LEC shall not unreasonably withhold approval of contractors. Approval by an incumbent LEC shall be based on the same criteria it uses in approving contractors for its own purposes.

Subpart E - Exemptions, Suspensions, and Modifications of Requirements of Section 251 of the Act.

§ 51.401 State authority.

A state commission shall determine whether a telephone company is entitled, pursuant to section 251(f) of the Act, to exemption from, or suspension or modification of, the requirements of section 251 of the Act. Such determinations shall be made on a case-by-case basis.

§ 51.403 Carriers eligible for suspension or modification under section 251(f)(2) of the Act.

A LEC is not eligible for a suspension or modification of the requirements of section 251(b) or section 251(c) of the Act pursuant to section 251(f)(2) of the Act if such LEC, at the holding company level, has two percent or more of the subscriber lines installed in the aggregate nationwide.

§ 51.405 Burden of proof.

(a) Upon receipt of a bona fide request for interconnection, services, or access to unbundled network elements, a rural telephone company must prove to the state commission that the rural telephone company should be entitled, pursuant to section 251(f)(1) of the Act, to continued exemption from the requirements of section 251(c) of the Act.

(b) A LEC with fewer than two percent of the nation's subscriber lines installed in the aggregate nationwide must prove to the state commission, pursuant to section 251(f)(2) of the Act, that it is entitled to a suspension or modification of the application of a requirement or requirements of section 251(b) or 251(c) of the Act.

(c) In order to justify continued exemption under section 251(f)(1) of the Act once a bona fide request has been made, an incumbent LEC must offer evidence that the application of the requirements of section 251(c) of the Act would be likely to cause undue economic burden beyond the economic burden that is typically associated with efficient competitive entry.

(d) In order to justify a suspension or modification under section 251(f)(2) of the Act, a LEC must offer evidence that the application of section 251(b) or section 251(c) of the Act would be likely to cause undue economic burden beyond the economic burden that is typically associated with efficient competitive entry.

Subpart F - Pricing of Elements.

§ 51.501 Scope.

(a) The rules in this subpart apply to the pricing of network elements, interconnection, and methods of obtaining access to unbundled elements, including physical collocation and virtual collocation.

(b) As used in this subpart, the term "element" includes network elements, interconnection, and methods of obtaining interconnection and access to unbundled elements.

§ 51.503 General pricing standard.

(a) An incumbent LEC shall offer elements to requesting telecommunications carriers at rates, terms, and conditions that are just, reasonable, and nondiscriminatory.

(b) An incumbent LEC's rates for each element it offers shall comply with the rate structure rules set forth in §§ 51.507 and 51.509 of this part, and shall be established, at the election of the state commission--

(1) pursuant to the forward-looking economic cost-based pricing methodology set forth in §§ 51.505 and 51.511 of this part; or

(2) consistent with the proxy ceilings and ranges set forth in § 51.513 of this

part.

(c) The rates that an incumbent LEC assesses for elements shall not vary on the basis of the class of customers served by the requesting carrier, or on the type of services that the requesting carrier purchasing such elements uses them to provide.

§ 51.505 Forward-looking economic cost.

(a) *In general*. The forward-looking economic cost of an element equals the sum of:

(1) the total element long-run incremental cost of the element, as described in paragraph (b); and

(2) a reasonable allocation of forward-looking common costs, as described in paragraph (c).

(b) *Total element long-run incremental cost*. The total element long-run incremental cost of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(1) *Efficient network configuration*. The total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

(2) *Forward-looking cost of capital*. The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element.

(3) *Depreciation rates*. The depreciation rates used in calculating forward-looking economic costs of elements shall be economic depreciation rates.

(c) *Reasonable allocation of forward-looking common costs*.

(1) *Forward-looking common costs*. Forward-looking common costs are economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent LEC) that cannot be attributed directly to individual elements or services.

(2) *Reasonable allocation*.

(A) The sum of a reasonable allocation of forward-looking common costs and the total element long-run incremental cost of an element shall not exceed the stand-alone costs associated with the element. In this context, stand-alone costs are the total forward-looking costs, including corporate costs, that would be incurred to produce a given element if that element were provided by an efficient firm that produced nothing but the given element.

(B) The sum of the allocation of forward-looking common costs for all elements and services shall equal the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LEC's total network, so as to provide all the elements and services offered.

(d) *Factors that may not be considered*. The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:

(1) *Embedded costs*. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts.

(2) *Retail costs*. Retail costs include the costs of marketing, billing, collection, and other costs associated with offering retail telecommunications services to subscribers who are not telecommunications carriers, described in § 51.609 of this part.

(3) *Opportunity costs*. Opportunity costs include the revenues that the incumbent LEC would have received for the sale of telecommunications services, in the absence of competition from telecommunications carrier that purchase elements.

(4) *Revenues to subsidize other services*. Revenues to subsidize other services include revenues associated with elements or telecommunications service offerings other than the element for which a rate is being established.

(e) *Cost study requirements*. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward-looking economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511 of this part.

(1) A state commission may set a rate outside the proxy ranges or above the proxy ceilings described in § 51.513 of this part only if that commission has given full and fair effect to the economic cost based pricing methodology described in this section and § 51.511 of this part in a state proceeding that meets the requirements of paragraph (e)(2) of this section.

(2) Any state proceeding conducted pursuant to this section shall provide notice and an opportunity for comment to affected parties and shall result in the creation of a written factual record that is sufficient for purposes of review. The record of any state proceeding in which a state commission considers a cost study for purposes of establishing rates under this section shall include any such cost study.

§ 51.507 General rate structure standard.

(a) Element rates shall be structured consistently with the manner in which the costs of providing the elements are incurred.

(b) The costs of dedicated facilities shall be recovered through flat-rated charges.

(c) The costs of shared facilities shall be recovered in a manner that efficiently apportions costs among users. Costs of shared facilities may be apportioned either through usage-sensitive charges or capacity-based flat-rated charges, if the state commission finds that such rates reasonably reflect the costs imposed by the various users.

(d) Recurring costs shall be recovered through recurring charges, unless an incumbent LEC proves to a state commission that such recurring costs are de minimis. Recurring costs shall be considered de minimis when the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

(e) State commissions may, where reasonable, require incumbent LECs to recover nonrecurring costs through recurring charges over a reasonable period of time. Nonrecurring

charges shall be allocated efficiently among requesting telecommunications carriers, and shall not permit an incumbent LEC to recover more than the total forward-looking economic cost of providing the applicable element.

(f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.

(1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in § 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.

(2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

§ 51.509 Rate structure standards for specific elements.

In addition to the general rules set forth in § 51.507 of this part, rates for specific elements shall comply with the following rate structure rules.

(a) *Local loops*. Loop costs shall be recovered through flat-rated charges.

(b) *Local switching*. Local switching costs shall be recovered through a combination of a flat-rated charge for line ports and one or more flat-rated or per-minute usage charges for the switching matrix and for trunk ports.

(c) *Dedicated transmission links*. Dedicated transmission link costs shall be recovered through flat-rated charges.

(d) *Shared transmission facilities between tandem switches and end offices*. The costs of shared transmission facilities between tandem switches and end offices may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.

(e) *Tandem switching*. Tandem switching costs may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.

(f) *Signaling and call-related database services*. Signaling and call-related database service costs shall be usage-sensitive, based on either the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, the cost of which shall be recovered through flat-rated charges.

(g) *Collocation*. Collocation costs shall be recovered consistent with the rate structure policies established in the *Expanded Interconnection* proceeding, CC Docket No. 91-141.

§ 51.511 Forward-looking economic cost per unit.

(a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505 of this part, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.

(b) (1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the discrete number of elements (*e.g.*, local loops or local switch ports) that the incumbent LEC uses or provides.

(2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the unit of measurement of the usage (*e.g.*, minutes of use or call-related database queries) of the element.

§ 51.513 Proxies for forward-looking economic cost.

(a) A state commission may determine that the cost information available to it with respect to one or more elements does not support the adoption of a rate or rates that are consistent with the requirements set forth in §§ 51.505 and 51.511 of this part. In that event, the state commission may establish a rate for an element that is consistent with the proxies specified in this section, provided that:

(1) any rate established through use of such proxies shall be superseded once the state commission has completed review of a cost study that complies with the forward-looking economic cost based pricing methodology described in §§ 51.505 and 51.511 of this part, and has concluded that such study is a reasonable basis for establishing element rates; and

(2) the state commission sets forth in writing a reasonable basis for its selection of a particular rate for the element.

(b) The constraints on proxy-based rates described in this section apply on a geographically averaged basis. For purposes of determining whether geographically deaveraged rates for elements comply with the provisions of this section, a geographically averaged proxy-based rate shall be computed based on the weighted average of the actual, geographically deaveraged rates that apply in separate geographic areas in a state.

(c) *Proxies for specific elements*.

(1) *Local loops*. For each state listed below, the proxy-based monthly rate for unbundled local loops, on a statewide weighted average basis, shall be no greater than the figures listed in the table below. (The Commission has not established a default proxy ceiling for loop rates in Alaska).

TABLE A

State	Proxy Ceiling	State	Proxy Ceiling
Alabama	$17.25	Nebraska	$18.05
Arizona	$12.85	Nevada	$18.95
Arkansas	$21.18	New Hampshire	$16.00
California	$11.10	New Jersey	$12.47
Colorado	$14.97	New Mexico	$18.66
Connecticut	$13.23	New York	$11.75
Delaware	$13.24	North Carolina	$16.71
District of Columbia	$10.81	North Dakota	$25.36
Florida	$13.68	Ohio	$15.73
Georgia	$16.09	Oklahoma	$17.63
Hawaii	$15.27	Oregon	$15.44
Idaho	$20.16	Pennsylvania	$12.30
Illinois	$13.12	Puerto Rico	$12.47
Indiana	$13.29	Rhode Island	$11.48
Iowa	$15.94	South Carolina	$17.07
Kansas	$19.85	South Dakota	$25.33
Kentucky	$16.70	Tennessee	$17.41
Louisiana	$16.98	Texas	$15.49
Maine	$18.69	Utah	$15.12
Maryland	$13.36	Vermont	$20.13
Massachusetts	$9.83	Virginia	$14.13
Michigan	$15.27	Washington	$13.37
Minnesota	$14.81	West Virginia	$19.25
Mississippi	$21.97	Wisconsin	$15.94
Missouri	$18.32	Wyoming	$25.11
Montana	$25.18		

(2) *Local switching*. The blended proxy-based rate for unbundled local switching shall be no greater than 0.4 cents ($0.004) per minute, and no less than 0.2 cents ($0.002) per minute, except that, where a state commission has, before August 8, 1996, established a rate less than or equal to 0.5 cents ($0.005) per minute, that rate may be retained pending completion of a forward-looking economic cost study. The blended rate for unbundled local switching shall be calculated as the sum of the following:

(A) the applicable flat-rated charges for subelements associated with unbundled local switching, such as line ports, divided by the projected average minutes of use per flat-rated subelement; and

(B) the applicable usage-sensitive charges for subelements associated with unbundled local switching, such as switching and trunk ports. A weighted average of such charges shall be used in appropriate circumstances, such as when peak and off-peak charges are used.

(3) *Dedicated transmission links*. The proxy-based rates for dedicated transmission links shall be no greater than the incumbent LEC's tariffed interstate charges for comparable entrance facilities or direct-trunked transport offerings, as described in §§ 69.110 and 69.112 of this chapter.

(4) *Shared transmission facilities between tandem switches and end offices*. The proxy-based rates for shared transmission facilities between tandem switches and end offices shall be no greater than the weighted per-minute equivalent of DS1 and DS3 interoffice dedicated transmission link rates that reflects the relative number of DS1 and DS3 circuits used in the tandem to end office links (or a surrogate based on the proportion of copper and fiber facilities in the interoffice network), calculated using a loading factor of 9,000 minutes per month per voice-grade circuit, as described in § 69.112 of this chapter.

(5) *Tandem switching*. The proxy-based rate for tandem switching shall be no greater than 0.15 cents ($0.0015) per minute of use.

(6) *Collocation*. To the extent that the incumbent LEC offers a comparable form of collocation in its interstate expanded interconnection tariffs, as described in §§ 64.1401 and 69.121 of this chapter, the proxy-based rates for collocation shall be no greater than the effective rates for equivalent services in the interstate expanded interconnection tariff. To the extent that the incumbent LEC does not offer a comparable form of collocation in its interstate expanded interconnection tariffs, a state commission may, in its discretion, establish a proxy-based rate, provided that the state commission sets forth in writing a reasonable basis for concluding that its rate would approximate the result of a forward-looking economic cost study, as described in § 51.505 of this part.

(7) *Signaling, call-related database, and other elements*. To the extent that the incumbent LEC has established rates for offerings comparable to other elements in its interstate access tariffs, and has provided cost support for those rates pursuant to § 61.49(h) of this chapter, the proxy-based rates for those elements shall be no greater than the effective rates for equivalent services in the interstate access tariffs. In other cases, the proxy-based rate shall be no greater than a rate based on direct costs plus a reasonable allocation of overhead loadings, pursuant to § 61.49(h) of this chapter.

§ 51.515 Application of access charges.

(a) Neither the interstate access charges described in part 69 nor comparable intrastate access charges shall be assessed by an incumbent LEC on purchasers of elements that offer telephone exchange or exchange access services.

(b) Notwithstanding §§ 51.505, 51.511, and 51.513(d)(2) of this part and paragraph (a) of this section, an incumbent LEC may assess upon telecommunications carriers that purchase unbundled local switching elements, as described in § 51.319(c)(1) of this part, for interstate minutes of use traversing such unbundled local switching elements, the carrier common line charge described in § 69.105 of this chapter, and a charge equal to 75% of the interconnection

charge described in § 69.124 of this chapter, only until the earliest of the following, and not thereafter:

(1) June 30, 1997;

(2) the later of the effective date of a final Commission decision in CC Docket No. 96-45, *Federal-State Joint Board on Universal Service*, or the effective date of a final Commission decision in a proceeding to consider reform of the interstate access charges described in part 69; or

(3) with respect to a Bell operating company only, the date on which that company is authorized to offer in-region interLATA service in a state pursuant to section 271 of the Act. The end date for Bell operating companies that are authorized to offer interLATA service shall apply only to the recovery of access charges in those states in which the Bell operating company is authorized to offer such service.

(c) Notwithstanding §§ 51.505, 51.511, and 51.513(d)(2) of this part and paragraph (a) of this section, an incumbent LEC may assess upon telecommunications carriers that purchase unbundled local switching elements, as described in § 51.319(c)(1) of this part, for intrastate toll minutes of use traversing such unbundled local switching elements, intrastate access charges comparable to those listed in paragraph (b) and any explicit intrastate universal service mechanism based on access charges, only until the earliest of the following, and not thereafter:

(1) June 30, 1997;

(2) the effective date of a state commission decision that an incumbent LEC may not assess such charges; or

(3) with respect to a Bell operating company only, the date on which that company is authorized to offer in-region interLATA service in the state pursuant to section 271 of the Act. The end date for Bell operating companies that are authorized to offer interLATA service shall apply only to the recovery of access charges in those states in which the Bell operating company is authorized to offer such service.

Subpart G - Resale.

§ 51.601 Scope of resale rules.

The provisions of this subpart govern the terms and conditions under which LECs offer telecommunications services to requesting telecommunications carriers for resale.

§ 51.603 Resale obligation of all local exchange carriers.

(a) A LEC shall make its telecommunications services available for resale to requesting telecommunications carriers on terms and conditions that are reasonable and non-discriminatory.

(b) A LEC must provide services to requesting telecommunications carriers for resale that are equal in quality, subject to the same conditions, and provided within the same provisioning time intervals that the LEC provides these services to others, including end users.

§ 51.605 Additional obligations of incumbent local exchange carriers.

(a) An incumbent LEC shall offer to any requesting telecommunications carrier any telecommunications service that the incumbent LEC offers on a retail basis to subscribers that are not telecommunications carriers for resale at wholesale rates that are at the election of the state commission–

(1) consistent with the avoided cost methodology described in §§ 51.607 and 51.609 of this part; or

(2) interim wholesale rates, pursuant to § 51.611 of this part,

(b) Except as provided in § 51.613 of this part, an incumbent LEC shall not impose restrictions on the resale by a requesting carrier of telecommunications services offered by the incumbent LEC.

§ 51.607 Wholesale pricing standard.

(a) The wholesale rate that an incumbent LEC may charge for a telecommunications service provided for resale to other telecommunications carriers shall equal the incumbent LEC's existing retail rate for the telecommunications service, less avoided retail costs, as described in § 51.609 of this part.

(b) For purposes of this subpart, exchange access services, as defined in section 3 of the Act, shall not be considered to be telecommunications services that incumbent LECs must make available for resale at wholesale rates to requesting telecommunications carriers.

§ 51.609 Determination of avoided retail costs.

(a) Except as provided in § 51.611 of this part, the amount of avoided retail costs shall be determined on the basis of a cost study that complies with the requirements of this section.

(b) Avoided retail costs shall be those costs that reasonably can be avoided when an incumbent LEC provides a telecommunications service for resale at wholesale rates to a requesting carrier.

(c) For incumbent LECs that are designated as Class A companies under § 32.11 of this chapter, except as provided in paragraph (d), avoided retail costs shall:

(1) include, as direct costs, the costs recorded in USOA accounts 6611 (product management), 6612 (sales), 6613 (product advertising), 6621 (call completion services), 6622 (number services), and 6623 (customer services) (§§ 32.6611, 32.6612, 32.6613, 32.6621, 32.6622, and 32.6623);

(2) include, as indirect costs, a portion of the costs recorded in USOA accounts 6121-6124 (general support expenses), 6711, 6712, 6721-6728 (corporate operations expenses), and 5301 (telecommunications uncollectibles) (§§ 32.6121-32.6124, 32.6711, 32.6712, 32.6721-32.6728, and 32.5301); and

(3) not include plant-specific expenses and plant non-specific expenses, other than

general support expenses (§§ 32.6110-32.6116, 32.6210-32.6565).

(d) Costs included in accounts 6611-6613 and 6621-6623 described in paragraph (c) (§§ 32.6611-32.6613 and 32.6621-32.6623) may be included in wholesale rates only to the extent that the incumbent LEC proves to a state commission that specific costs in these accounts will be incurred and are not avoidable with respect to services sold at wholesale, or that specific costs in these accounts are not included in the retail prices of resold services. Costs included in accounts 6110-6116 and 6210-6565 described in paragraph (c) (§§ 32.6110-32.6116, 32.6210-32.6565) may be treated as avoided retail costs, and excluded from wholesale rates, only to the extent that a party proves to a state commission that specific costs in these accounts can reasonably be avoided when an incumbent LEC provides a telecommunications service for resale to a requesting carrier.

(e) For incumbent LECs that are designated as Class B companies under § 32.11 of this chapter and that record information in summary accounts instead of specific USOA accounts, the entire relevant summary accounts may be used in lieu of the specific USOA accounts listed in paragraphs (c) and (d).

§ 51.611 Interim wholesale rates.

(a) If a state commission cannot, based on the information available to it, establish a wholesale rate using the methodology prescribed in § 51.609 of this part, then the state commission may elect to establish an interim wholesale rate as described in paragraph (b) of this section.

(b) The state commission may establish interim wholesale rates that are at least 17 percent, and no more than 25 percent, below the incumbent LEC's existing retail rates, and shall articulate the basis for selecting a particular discount rate. The same discount percentage rate shall be used to establish interim wholesale rates for each telecommunications service.

(c) A state commission that establishes interim wholesale rates shall, within a reasonable period of time thereafter, establish wholesale rates on the basis of an avoided retail cost study that complies with § 51.609 of this part.

§ 51.613 Restrictions on resale.

(a) Notwithstanding § 51.605(b) of this part, the following types of restrictions on resale may be imposed:

(1) *Cross-class selling*. A state commission may permit an incumbent LEC to prohibit a requesting telecommunications carrier that purchases at wholesale rates for resale, telecommunications services that the incumbent LEC makes available only to residential customers or to a limited class of residential customers, from offering such services to classes of customers that are not eligible to subscribe to such services from the incumbent LEC.

(2) *Short term promotions*. An incumbent LEC shall apply the wholesale discount to the ordinary rate for a retail service rather than a special promotional rate only if:

(A) such promotions involve rates that will be in effect for no more than 90 days; and

(B) the incumbent LEC does not use such promotional offerings to evade the wholesale rate obligation, for example by making available a sequential series of 90-day promotional rates.

(b) With respect to any restrictions on resale not permitted under paragraph (a), an incumbent LEC may impose a restriction only if it proves to the state commission that the restriction is reasonable and nondiscriminatory.

(c) *Branding*. Where operator, call completion, or directory assistance service is part of the service or service package an incumbent LEC offers for resale, failure by an incumbent LEC to comply with reseller unbranding or rebranding requests shall constitute a restriction on resale.

(1) An incumbent LEC may impose such a restriction only if it proves to the state commission that the restriction is reasonable and nondiscriminatory, such as by proving to a state commission that the incumbent LEC lacks the capability to comply with unbranding or rebranding requests.

(2) For purposes of this subpart, unbranding or rebranding shall mean that operator, call completion, or directory assistance services are offered in such a manner that an incumbent LEC's brand name or other identifying information is not identified to subscribers, or that such services are offered in such a manner that identifies to subscribers the requesting carrier's brand name or other identifying information.

§ 51.615 Withdrawal of services.

When an incumbent LEC makes a telecommunications service available only to a limited group of customers that have purchased such a service in the past, the incumbent LEC must also make such a service available at wholesale rates to requesting carriers to offer on a resale basis to the same limited group of customers that have purchased such a service in the past.

§ 51.617 Assessment of end user common line charge on resellers.

(a) Notwithstanding the provision in § 69.104(a) of this chapter that the end user common line charge be assessed upon end users, an incumbent LEC shall assess this charge, and the charge for changing the designated primary interexchange carrier, upon requesting carriers that purchase telephone exchange service for resale. The specific end user common line charge to be assessed will depend upon the identity of the end user served by the requesting carrier.

(b) When an incumbent LEC provides telephone exchange service to a requesting carrier at wholesale rates for resale, the incumbent LEC shall continue to assess the interstate access

charges provided in part 69, other than the end user common line charge, upon interexchange carriers that use the incumbent LEC's facilities to provide interstate or international telecommunications services to the interexchange carriers' subscribers.

Subpart H - Reciprocal Compensation for Transport and Termination of Local Telecommunications Traffic.

§ 51.701 Scope of transport and termination pricing rules.

(a) The provisions of this subpart apply to reciprocal compensation for transport and termination of local telecommunications traffic between LECs and other telecommunications carriers.

(b) *Local telecommunications traffic*. For purposes of this subpart, local telecommunications traffic means:

(1) telecommunications traffic between a LEC and a telecommunications carrier other than a CMRS provider that originates and terminates within a local service area established by the state commission; or

(2) telecommunications traffic between a LEC and a CMRS provider that, at the beginning of the call, originates and terminates within the same Major Trading Area, as defined in § 24.202(a) of this chapter.

(c) *Transport*. For purposes of this subpart, transport is the transmission and any necessary tandem switching of local telecommunications traffic subject to section 251(b)(5) of the Act from the interconnection point between the two carriers to the terminating carrier's end office switch that directly serves the called party, or equivalent facility provided by a carrier other than an incumbent LEC.

(d) *Termination*. For purposes of this subpart, termination is the switching of local telecommunications traffic at the terminating carrier's end office switch, or equivalent facility, and delivery of such traffic to the called party's premises.

(e) *Reciprocal compensation*. For purposes of this subpart, a reciprocal compensation arrangement between two carriers is one in which each of the two carriers receives compensation from the other carrier for the transport and termination on each carrier's network facilities of local telecommunications traffic that originates on the network facilities of the other carrier.

§ 51.703 Reciprocal compensation obligation of LECs.

(a) Each LEC shall establish reciprocal compensation arrangements for transport and termination of local telecommunications traffic with any requesting telecommunications carrier.

(b) A LEC may not assess charges on any other telecommunications carrier for local telecommunications traffic that originates on the LEC's network.

§ 51.705 Incumbent LECs' rates for transport and termination.

(a) An incumbent LEC's rates for transport and termination of local telecommunications traffic shall be established, at the election of the state commission, on the basis of:

(1) the forward-looking economic costs of such offerings, using a cost study pursuant to §§ 51.505 and 51.511 of this part;

(2) default proxies, as provided in § 51.707 of this part; or

(3) a bill-and-keep arrangement, as provided in § 51.713 of this part.

(b) In cases where both carriers in a reciprocal compensation arrangement are incumbent LECs, state commissions shall establish the rates of the smaller carrier on the basis of the larger carrier's forward-looking costs, pursuant to § 51.711 of this part.

§ 51.707 Default proxies for incumbent LECs' transport and termination rates.

(a) A state commission may determine that the cost information available to it with respect to transport and termination of local telecommunications traffic does not support the adoption of a rate or rates for an incumbent LEC that are consistent with the requirements of §§ 51.505 and 51.511 of this part. In that event, the state commission may establish rates for transport and termination of local telecommunications traffic, or for specific components included therein, that are consistent with the proxies specified in this section, provided that:

(1) any rate established through use of such proxies is superseded once that state commission establishes rates for transport and termination pursuant to §§ 51.705(a)(1) or 51.705(a)(3) of this part; and

(2) the state commission sets forth in writing a reasonable basis for its selection of a particular proxy for transport and termination of local telecommunications traffic, or for specific components included within transport and termination.

(b) If a state commission establishes rates for transport and termination of local telecommunications traffic on the basis of default proxies, such rates must meet the following requirements:

(1) *Termination*. The incumbent LEC's rates for the termination of local telecommunications traffic shall be no greater than 0.4 cents ($0.004) per minute, and no less than 0.2 cents ($0.002) per minute, except that, if a state commission has, before August 8, 1996, established a rate less than or equal to 0.5 cents ($0.005) per minute for such calls, that rate may be retained pending completion of a forward-looking economic cost study.

(2) *Transport*. The incumbent LEC's rates for the transport of local telecommunications traffic, under this section, shall comply with the proxies described in § 51.513(d)(3), (4), and (5) of this part that apply to the analogous unbundled network elements used in transporting a call to the end office that serves the called party.

§ 51.709 Rate structure for transport and termination.

(a) In state proceedings, a state commission shall establish rates for the transport and termination of local telecommunications traffic that are structured consistently with the manner

that carriers incur those costs, and consistently with the principles in §§ 51.507 and 51.509 of this part.

(b) The rate of a carrier providing transmission facilities dedicated to the transmission of traffic between two carriers' networks shall recover only the costs of the proportion of that trunk capacity used by an interconnecting carrier to send traffic that will terminate on the providing carrier's network. Such proportions may be measured during peak periods.

§ 51.711 Symmetrical reciprocal compensation.

(a) Rates for transport and termination of local telecommunications traffic shall be symmetrical, except as provided in paragraphs (b) and (c).

(1) For purposes of this subpart, symmetrical rates are rates that a carrier other than an incumbent LEC assesses upon an incumbent LEC for transport and termination of local telecommunications traffic equal to those that the incumbent LEC assesses upon the other carrier for the same services.

(2) In cases where both parties are incumbent LECs, or neither party is an incumbent LEC, a state commission shall establish the symmetrical rates for transport and termination based on the larger carrier's forward-looking costs.

(3) Where the switch of a carrier other than an incumbent LEC serves a geographic area comparable to the area served by the incumbent LEC's tandem switch, the appropriate rate for the carrier other than an incumbent LEC is the incumbent LEC's tandem interconnection rate.

(b) A state commission may establish asymmetrical rates for transport and termination of local telecommunications traffic only if the carrier other than the incumbent LEC (or the smaller of two incumbent LECs) proves to the state commission on the basis of a cost study using the forward-looking economic cost based pricing methodology described in §§ 51.505 and 51.511 of this part, that the forward-looking costs for a network efficiently configured and operated by the carrier other than the incumbent LEC (or the smaller of two incumbent LECs), exceed the costs incurred by the incumbent LEC (or the larger incumbent LEC), and, consequently, that such that a higher rate is justified.

(c) Pending further proceedings before the Commission, a state commission shall establish the rates that licensees in the Paging and Radiotelephone Service (defined in part 22, subpart E of this chapter), Narrowband Personal Communications Services (defined in part 24, subpart D of this chapter), and Paging Operations in the Private Land Mobile Radio Services (defined in part 90, subpart P of this chapter) may assess upon other carriers for the transport and termination of local telecommunications traffic based on the forward-looking costs that such licensees incur in providing such services, pursuant to §§ 51.505 and 51.511 of this part. Such licensees' rates shall not be set based on the default proxies described in § 51.707 of this part.

§ 51.713 Bill-and-keep arrangements for reciprocal compensation.

(a) For purposes of this subpart, bill-and-keep arrangements are those in which neither

of the two interconnecting carriers charges the other for the termination of local telecommunications traffic that originates on the other carrier's network.

(b) A state commission may impose bill-and-keep arrangements if the state commission determines that the amount of local telecommunications traffic from one network to the other is roughly balanced with the amount of local telecommunications traffic flowing in the opposite direction, and is expected to remain so, and no showing has been made pursuant to § 51.711(b) of this part.

(c) Nothing in this section precludes a state commission from presuming that the amount of local telecommunications traffic from one network to the other is roughly balanced with the amount of local telecommunications traffic flowing in the opposite direction and is expected to remain so, unless a party rebuts such a presumption.

§ 51.715 Interim transport and termination pricing.

(a) Upon request from a telecommunications carrier without an existing interconnection arrangement with an incumbent LEC, the incumbent LEC shall provide transport and termination of local telecommunications traffic immediately under an interim arrangement, pending resolution of negotiation or arbitration regarding transport and termination rates and approval of such rates by a state commission under sections 251 and 252 of the Act.

(1) This requirement shall not apply when the requesting carrier has an existing interconnection arrangement that provides for the transport and termination of local telecommunications traffic by the incumbent LEC.

(2) A telecommunications carrier may take advantage of such an interim arrangement only after it has requested negotiation with the incumbent LEC pursuant to § 51.301 of this part.

(b) Upon receipt of a request as described in paragraph (a), an incumbent LEC must, without unreasonable delay, establish an interim arrangement for transport and termination of local telecommunications traffic at symmetrical rates.

(1) In a state in which the state commission has established transport and termination rates based on forward-looking economic cost studies, an incumbent LEC shall use these state-determined rates as interim transport and termination rates.

(2) In a state in which the state commission has established transport and termination rates consistent with the default price ranges and ceilings described in § 51.707 of this part, an incumbent LEC shall use these state-determined rates as interim rates.

(3) In a state in which the state commission has neither established transport and termination rates based on forward-looking economic cost studies nor established transport and termination rates consistent with the default price ranges described in § 51.707 of this part, an incumbent LEC shall set interim transport and termination rates at the default ceilings for end-office switching (0.4 cents per minute of use), tandem switching (0.15 cents per minute of use), and transport (as described in § 51.707(b)(2) of this part).

(c) An interim arrangement shall cease to be in effect when one of the following occurs

with respect to rates for transport and termination of local telecommunications traffic subject to the interim arrangement:

(1) a voluntary agreement has been negotiated and approved by a state commission;

(2) an agreement has been arbitrated and approved by a state commission; or

(3) the period for requesting arbitration has passed with no such request.

(d) If the rates for transport and termination of local telecommunications traffic in an interim arrangement differ from the rates established by a state commission pursuant to § 51.705 of this part, the state commission shall require carriers to make adjustments to past compensation. Such adjustments to past compensation shall allow each carrier to receive the level of compensation it would have received had the rates in the interim arrangement equalled the rates later established by the state commission pursuant to § 51.705 of this part.

§ 51.717 Renegotiation of existing non-reciprocal arrangements.

(a) Any CMRS provider that operates under an arrangement with an incumbent LEC that was established before August 8, 1996 and that provides for non-reciprocal compensation for transport and termination of local telecommunications traffic is entitled to renegotiate these arrangements with no termination liability or other contract penalties.

(b) From the date that a CMRS provider makes a request under paragraph (a) until a new agreement has been either arbitrated or negotiated and has been approved by a state commission, the CMRS provider shall be entitled to assess upon the incumbent LEC the same rates for the transport and termination of local telecommunications traffic that the incumbent LEC assesses upon the CMRS provider pursuant to the pre-existing arrangement.

Subpart I - Procedures for Implementation of Section 252 of the Act.

§ 51.801 Commission action upon a state commission's failure to act to carry out its responsibility under section 252 of the Act.

(a) If a state commission fails to act to carry out its responsibility under section 252 of the Act in any proceeding or other matter under section 252 of the Act, the Commission shall issue an order preempting the state commission's jurisdiction of that proceeding or matter within 90 days after being notified (or taking notice) of such failure, and shall assume the responsibility of the state commission under section 252 of the Act with respect to the proceeding or matter and shall act for the state commission.

(b) For purposes of this part, a state commission fails to act if the state commission fails to respond, within a reasonable time, to a request for mediation, as provided for in section 252(a)(2) of the Act, or for a request for arbitration, as provided for in section 252(b) of the Act, or fails to complete an arbitration within the time limits established in section 252(b)(4)(C) of the Act.

(c) A state shall not be deemed to have failed to act for purposes of section 252(e)(5) of the Act if an agreement is deemed approved under section 252(e)(4) of the Act.

§ 51.803 Procedures for Commission notification of a state commission's failure to act.

(a) Any party seeking preemption of a state commission's jurisdiction, based on the state commission's failure to act, shall notify the Commission in accordance with following procedures:

(1) such party shall file with the Secretary of the Commission a petition, supported by an affidavit, that states with specificity the basis for the petition and any information that supports the claim that the state has failed to act, including, but not limited to, the applicable provisions of the Act and the factual circumstances supporting a finding that the state commission has failed to act;

(2) such party shall ensure that the state commission and the other parties to the proceeding or matter for which preemption is sought are served with the petition required in paragraph (a)(1) of this section on the same date that the petitioning party serves the petition on the Commission; and

(3) within fifteen days from the date of service of the petition required in paragraph (a)(1) of this section, the applicable state commission and parties to the proceeding may file with the Commission a response to the petition.

(b) The party seeking preemption must prove that the state has failed to act to carry out its responsibilities under section 252 of the Act.

(c) The Commission, pursuant to section 252(e)(5) of the Act, may take notice upon its own motion that a state commission has failed to act. In such a case, the Commission shall issue a public notice that the Commission has taken notice of a state commission's failure to act. The applicable state commission and the parties to a proceeding or matter in which the Commission has taken notice of the state commission's failure to act may file, within fifteen days of the issuance of the public notice, comments on whether the Commission is required to assume the responsibility of the state commission under section 252 of the Act with respect to the proceeding or matter.

(d) The Commission shall issue an order determining whether it is required to preempt the state commission's jurisdiction of a proceeding or matter within 90 days after being notified under paragraph (a) of this section or taking notice under paragraph (c) of this section of a state commission's failure to carry out its responsibilities under section 252 of the Act.

§ 51.805 The Commission's authority over proceedings and matters.

(a) If the Commission assumes responsibility for a proceeding or matter pursuant to section 252(e)(5) of the Act, the Commission shall retain jurisdiction over such proceeding or matter. At a minimum, the Commission shall approve or reject any interconnection agreement adopted by negotiation, mediation or arbitration for which the Commission, pursuant to section

252(e)(5) of the Act, has assumed the state's commission's responsibilities.

(b) Agreements reached pursuant to mediation or arbitration by the Commission pursuant to section 252(e)(5) of the Act are not required to be submitted to the state commission for approval or rejection.

§ 51.807 Arbitration and mediation of agreements by the Commission pursuant to section 252(e)(5) of the Act.

(a) The rules established in this section shall apply only to instances in which the Commission assumes jurisdiction under section 252(e)(5) of the Act.

(b) When the Commission assumes responsibility for a proceeding or matter pursuant to section 252(e)(5) of the Act, it shall not be bound by state laws and standards that would have applied to the state commission in such proceeding or matter.

(c) In resolving, by arbitration under section 252(b) of the Act, any open issues and in imposing conditions upon the parties to the agreement, the Commission shall:

(1) ensure that such resolution and conditions meet the requirements of section 251 of the Act, including the rules prescribed by the Commission pursuant to that section;

(2) establish any rates for interconnection, services, or network elements according to section 252(d) of the Act, including the rules prescribed by the Commission pursuant to that section; and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.

(d) An arbitrator, acting pursuant to the Commission's authority under section 252(e)(5) of the Act, shall use final offer arbitration, except as otherwise provided in this section:

(1) at the discretion of the arbitrator, final offer arbitration may take the form of either entire package final offer arbitration or issue-by-issue final offer arbitration.

(2) negotiations among the parties may continue, with or without the assistance of the arbitrator, after final arbitration offers are submitted. Parties may submit subsequent final offers following such negotiations.

(3) to provide an opportunity for final post-offer negotiations, the arbitrator will not issue a decision for at least fifteen days after submission to the arbitrator of the final offers by the parties.

(e) Final offers submitted by the parties to the arbitrator shall be consistent with section 251 of the Act, including the rules prescribed by the Commission pursuant to that section.

(f) Each final offer shall:

(1) meet the requirements of section 251, including the rules prescribed by the Commission pursuant to that section;

(2) establish rates for interconnection, services, or access to unbundled network elements according to section 252(d) of the Act, including the rules prescribed by the

Commission pursuant to that section, and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement. If a final offer submitted by one or more parties fails to comply with the requirements of this section, the arbitrator has discretion to take steps designed to result in an arbitrated agreement that satisfies the requirements of section 252(c) of the Act, including requiring parties to submit new final offers within a time frame specified by the arbitrator, or adopting a result not submitted by any party that is consistent with the requirements of section 252(c) of the Act, and the rules prescribed by the Commission pursuant to that section.

(g) Participation in the arbitration proceeding will be limited to the requesting telecommunications carrier and the incumbent LEC, except that the Commission will consider requests by third parties to file written pleadings.

(h) Absent mutual consent of the parties to change any terms and conditions adopted by the arbitrator, the decision of the arbitrator shall be binding on the parties.

§ 51.809 Availability of provisions of agreements to other telecommunications carriers under section 252(i) of the Act.

(a) An incumbent LEC shall make available without unreasonable delay to any requesting telecommunications carrier any individual interconnection, service, or network element arrangement contained in any agreement to which it is a party that is approved by a state commission pursuant to section 252 of the Act, upon the same rates, terms, and conditions as those provided in the agreement. An incumbent LEC may not limit the availability of any individual interconnection, service, or network element only to those requesting carriers serving a comparable class of subscribers or providing the same service (*i.e.*, local, access, or interexchange) as the original party to the agreement.

(b) The obligations of paragraph (a) of this section shall not apply where the incumbent LEC proves to the state commission that:

(1) the costs of providing a particular interconnection, service, or element to the requesting telecommunications carrier are greater than the costs of providing it to the telecommunications carrier that originally negotiated the agreement, or

(2) the provision of a particular interconnection, service, or element to the requesting carrier is not technically feasible.

(c) Individual interconnection, service, or network element arrangements shall remain available for use by telecommunications carriers pursuant to this section for a reasonable period of time after the approved agreement is available for public inspection under section 252(f) of the Act.

14. Part 90 of Title 47 of the Code of Federal Regulations (C.F.R.) is amended as follows:

PART 90 - PRIVATE LAND MOBILE RADIO SERVICES

15. The authority citation for Part 90 is revised to read as follows:

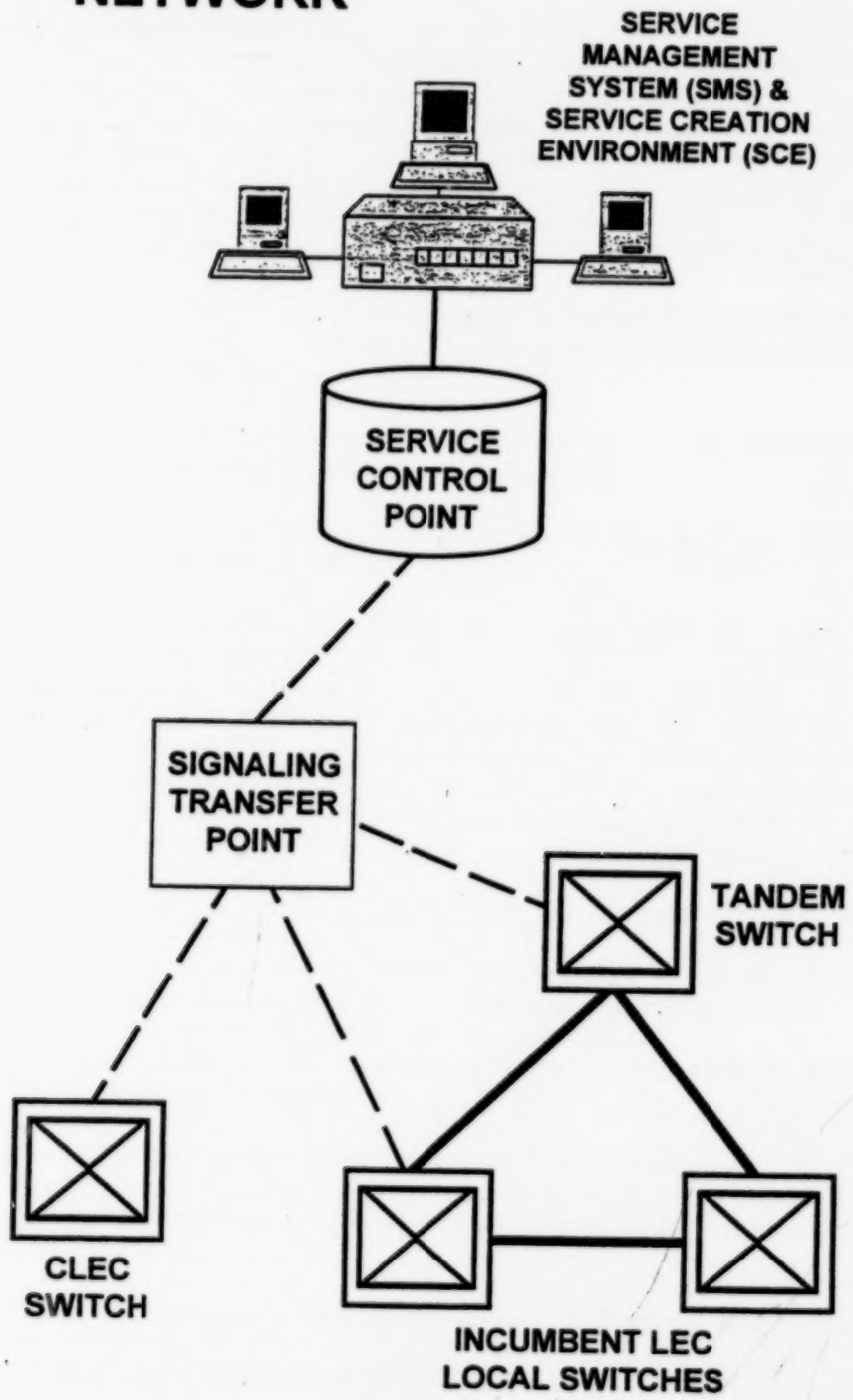
AUTHORITY: Secs. 4, 251-2, 303, 309, and 332, 48 Stat. 1066, 1082, as amended; 47 U.S.C. 154, 251-2, 303, 309 and 332, unless otherwise noted.

16. Section 90.5 is amended by adding paragraph (k) and renumbering the remaining paragraphs to read as follows:

*****

(k) Part 51 contains rules relating to interconnection.
(l) ***
(m) ***

ADVANCED INTELLIGENT NETWORK



1239

16237

Appendix D
State Proxy Ceilings for the Local Loop

State	Proxy Ceiling	State	Proxy Ceiling
Alabama	$17.25	Montana	$25.18
Arizona	$12.85	Nebraska	$18.05
Arkansas	$21.18	Nevada	$18.95
California	$11.10	New Hampshire	$16.00
Colorado	$14.97	New Jersey	$12.47
Connecticut	$13.23	New Mexico	$18.66
Delaware	$13.24	New York	$11.75
District of Columbia	$10.81	North Carolina	$16.71
Florida	$13.68	North Dakota	$25.36
Georgia	$16.09	Ohio	$15.73
Hawaii	$15.27	Oklahoma	$17.63
Idaho	$20.16	Oregon	$15.44
Illinois	$13.12	Pennsylvania	$12.30
Indiana	$13.29	Puerto Rico	$12.47
Iowa	$15.94	Rhode Island	$11.48
Kansas	$19.85	South Carolina	$17.07
Kentucky	$16.70	South Dakota	$25.33
Louisiana	$16.98	Tennessee	$17.41
Maine	$18.69	Texas	$15.49
Maryland	$13.36	Utah	$15.12
Massachusetts	$9.83	Vermont	$20.13
Michigan	$15.27	Virginia	$14.13
Minnesota	$14.81	Washington	$13.37
Mississippi	$21.97	West Virginia	$19.25
Missouri	$18.32	Wisconsin	$15.94
		Wyoming	$25.11

1240

16238

August 8, 1996

In the Matter of
Implementation of the Local Competition Provisions in
the Telecommunications Act of 1996 (CC Docket No. 96-98)
and
Interconnection between Local Exchange Carriers and
Commercial Mobile Radio Service Providers (CC Docket No. 95-185)

Separate Statement of Chairman Reed E. Hundt

This order is the most pro-competitive action of government since the break-up of the Standard Oil Trust. I hope the whole country will join in common acknowledgement of all those who made this possible.

The private sector was ably represented, and provided us with much useful information and suggestions.

I specifically acknowledge and thank my colleagues, Commissioners Quello, Ness and Chong, and their staffs, all of whom contributed greatly throughout this process.

I would also especially thank Cheryl Parrino, President of the National Association of Regulatory Utility Commissioners. Her advice and counsel have been invaluable. Thanks also go to the two individuals who served as Chair of NARUC's Communications Committee during this period, Ken McClure and Lisa Rosenblum. I also thank the many other state commissioners from around the country who took time to discuss these matters with us, and who sent their staffs here for extended meetings on all these issues. I would also especially thank Chairman Dan Miller of the Illinois Commerce Committee who detailed one of his staff members, Augie Ros, to the FCC.

I owe a special debt of gratitude and respect to John Nakahata, my Senior Legal Adviser. John's brilliant, indefatigable, incisive and comprehensive work was essential to the triumph of analysis and policy that is in this order.

The highest commendations, however, go to the FCC staff, superbly led by Regina Keeney and Richard Metzger. I would like specifically to recognize each of the dedicated members of the Commission's staff who contributed to this effort, and I apologize if I have inadvertently omitted anyone:

COMMON CARRIER BUREAU

Competitive Pricing Division

Jay Atkinson
Dana Bradford
C. Anthony Bush
Paul D'Ari
Whitney Fox
Aaron Goldschmidt
Lori Huthoefer
Jane Jackson
Cameron Kashani
Dave Konuch
Ed Krachmer
Rich Lerner
Jim Schlichting
Katherine Schroder
John Scott
Les Selzer
Raj Kannan
Bill Sharkey
David Sieradzki
Doug Slotten
Joel Taubenblatt
Matt Warren
Steve Weingarten
Kevin Werbach
Brad Wimmer

Policy and Program Planning Division

Craig Brown
Michelle Carey
Patrick Degraba
David Ellen
Kathleen Franco
Paul Gallant
Lisa Gelb
Jason Grant
Florence Grasso
James Graves
Adam Guglielmo
Kalpak Gude
Matt Harthun

Policy and Program (cont.)

Christopher Heimann
Cindy Jackson
Radhika Karmarkar
Jason Karp
Linda Kinney
Anil Koshy
Stuart Kupinsky
Cheryl Leanza
Mindy Littell
Debbie Maisel
Carol Mattey
Robert McDonald
Susan McMaster
Makysha J. Moton
Janice M. Myles
Brent Olson
Claudia Pabo
Staci Pies
Michael Pryor
Augie Ros
Tonya Rutherford
Cecilia Sangley
Blaise Scinto
Ann Stevens
Donald Stockdale
Jeannie Su
Robert Tanner
Melissa Waksman
Richard Welch
Tracy Wilson
Jim Yancey

Accounting and Audits Division

Ken Moran
David Ahn
Leo Bridge
Chuck Needy

Common Carrier Bureau (cont.)

Enforcement Division

Adrien Auger
Anita Cheng
John Muleta

Industry Analysis Division

Tom Beers
Nasir Khilji
Jim Lande
Peyton Wynns

Network Services Division

Judy Albert
Renee Alexander
Lisa Boehley
Rich Cameron
Erin Duffy
Andy Firth
Octavia Florence
Gregory Forbes
Mary DeLuca
Pam Gerr
Marian Gordon
Bill Howden
Amy Lesch
Geri Matise
Kent Nilsson
Vin Paladini
Scott Shefferman

Office of the Bureau Chief

Regina Keeney
Kathie Levitz
Richard Metzger
Mary Beth Richards
Larry Atlas
Greg Rosston
Anna Gomez
Melissa Newman
Tim Peterson
Mindy J. Ginsburg
Andre Copelin
Shirley Chisolm
Lisa Bray
Chris Day
Brian Hughes

INTERNATIONAL BUREAU

Don Gips
Ruth Milkman
Fern Jarmulnek
Kerry Murray
Susan O'Connell

CABLE SERVICES BUREAU

Meredith Jones
John Logan
Libby Beaty
Barbara Esbin
Paul Glenchur
Alexis Johns
JoAnn Lucanik
Mike McMenamin
Tom Power
Len Smith
Les Smith
Nancy Stevenson

OFFICE OF GENERAL COUNSEL

Bill Kennard
Margie Bertman
Nick Bourne
Pat Carney
Sharon Diskin
Doron Fertig
Sheldon Guttmann
John Ingle
Aliza Katz
Joel Kaufman
Tom Koutsky
Jeff Lanning
Sev MacPete
Jim Olson
Sonja Rifken
Larry Schecker
David Solomon
Susan Steiman
Suzanne Tetreault
Debra Weiner
Chris Wright

OFFICE OF ENGINEERING AND TECHNOLOGY

Jim Keegan
Bob Kimball

OFFICE OF PLANS AND POLICY

Joe Farrell
Bob Pepper
Elliot Maxwell

OFFICE OF PUBLIC AFFAIRS

Susan Lewis Sallet

WIRELESS TELECOMMUNICATIONS BUREAU

Michele Farquhar
Karen Brinkmann
Jim Coltharp
Walt Strack
Daniel Grosh
Kathy O'Brien
Jeff Steinburg
Rhonda Lien
Zenji Nakazawa
David Nall
Jay Markley

PRINTING AND GRAPHICS BRANCH

Dan Walker
Tyrone Campfield
Ronnie Murray
Carlyn Walker

STATEMENT OF
COMMISSIONER JAMES H. QUELLO

August 8, 1996

Re: Interconnection Report and Order

Today marks the end of the pre-competitive era in local telephone service. By our vote today the Commission implements rules that will introduce competition into this last monopoly telecommunications market.

Our Report and Order refers to these rules as the first part of a trilogy that also includes future universal service and access charge reform. This is, to be sure, true. But I must confess that I also see today's action as not the first, but rather the third and final part, of a different trilogy -- one whose first two parts were the introduction of competition into the long-distance telephone market and the divestiture of the Bell Operating Companies from AT&T. These first two events made local telephone competition inevitable; today we usher it in.

Any Commissioner would be privileged to have served during one of these events. I have been lucky enough to have seen all three. From this perspective, then, I would offer several thoughts to the parties most immediately affected by today's decision.

First, to the public, I would say: unparalleled changes in the array of telecommunications services available to you, as well as in the companies that provide them, are going to occur. As competition proliferates and prices fall, economic growth will also occur, and that too will benefit all of us. This is the vision of the 1996 Act, and it is the goal of the rules we adopt today.

To those companies that seek to offer competitive local telephone service, I would say: the rules we adopt today attempt to provide the regulatory assistance you need to enter a market in which your competitor not only possesses a monopoly, but also controls the facilities upon which you must depend to compete. But even so, our rules are pro-competition, not pro-competitor. They are intended to make it possible for you to enter the market on fair and equitable terms, but not to so alter the market that entry occurs even where it otherwise might not. We have opened the door, but we have not paved the way.

To the wireless communications providers, I would say: we have heard and understand your concerns regarding the differences in your technical and market configurations and have, therefore, expressly reserved federal jurisdiction under Section 332. Nevertheless, it is important that our decisions implementing competition be technology-neutral and

provide an opportunity for negotiations under the comprehensive interconnection regime embodied by Congress in Section 251. We will presume good faith negotiations by all but stand ever vigilant to consider and resolve instances of discriminatory treatment.

To our state commission counterparts, I would say: with today's action, we effectively pass you the pen. It is now your responsibility to write the rules and set the prices and terms that will make Congress's vision of competition a reality. To provide added flexibility and to make this process administratively easier, we have also provided ranges of proxy prices that can be used until, or even instead of, state-specific rates are set. Our decision today borrows from and builds on the experience of those of you who are grappling with statewide competition issues. This has, in sum, been a collaborative process. It must continue to be a collaborative process if we are collectively to succeed.

To small telephone companies, I would say: our Report and Order relies largely on state commissions to implement the provisions of the law that ensure that competition will be introduced in a way that is sensitive to your unique circumstances. We cannot, and indeed would not want to, perpetuate what one small company has called a "reasonable, investment-backed expectation to hold competitive advantages over new market entrants." But while we will not guarantee your current profit margins, we are also confident that state decisions will assure that competition in your service areas will take hold in a reasonable manner.

To the Bell Operating Companies and other large independent local telcos, I would say: these rules will bring about competition. You will open your markets to competitors, and in return you will become competitors in other markets. The rules we adopt today will enable you to do both things. What they will not enable you to do is avoid the first, but obtain the second. These rules will bring change, not catastrophe; they will bring opportunity, not oblivion. It will be a different world, but one in which you will continue to play a vital role.

Finally, I must acknowledge that this day would not have come without the tireless dedication and tremendous talents of Gina Keeney and her gifted Common Carrier Bureau staff. The Chairman will, I am sure, commend each of you at length, and I will leave that privilege to him. For my part I want to express my thanks to the entire CCB "Dream Team," and especially to its captain, Richard Metzger. This job could literally not have been done this well in such short time without you, and for that you have my profound respect and appreciation.

August 8, 1996

SEPARATE STATEMENT
OF
COMMISSIONER SUSAN NESS

Re: Implementation of the Local Competition Provisions of the Telecommunications Act of 1996

Today we are fulfilling one of the most important responsibilities assigned to us by the Telecommunications Act of 1996 -- writing the rules that will achieve Congress's vision of fair and robust competition in all telecommunications markets. We are doing so with utmost fidelity to the letter and the spirit of the statute.

At the heart of the legislation is a bold commitment to supplant monopoly with competition. Based on the abundant benefits that have flowed to consumers as a result of competition in the provision of long distance services, information services, and customer-premises equipment, Congress decreed that the opportunity for competition be extended to the local telephone market. It ordered that barriers to entry be swept aside -- and that pathways to competitive entry be opened.

Sections 251 and 252 of the 1996 Act establish the foundation for this competition. On this foundation must be built radically different relationships than those that have previously existed -- between incumbent local exchange carriers and new entrants, between state and federal regulators, and between regulators and industry.

Congress recognizes that, to effectuate a new policy of local competition for markets that have traditionally been protected monopolies, a national policy framework is essential. But it also recognizes the need for flexibility. This balance is reflected in the 1996 Act, which sets forth the key principles in the statute, instructs this Commission to formulate implementing regulations, and assigns many of the duties pertaining to specific carriers and agreements to the state commissions.

At the same time, Congress encouraged voluntary negotiations between incumbent local exchange carriers and new entrants. Although voluntary agreements are not subject to Section 251 and our implementing regulations, we are aware that the negotiations may be influenced by the legislative and regulatory regime for arbitrated agreements. The "backdrop" of our rules should encourage, not impede, the successful negotiation of voluntary agreements.

The 1996 Act intends that the benefits of competition be available in all 50 states. not some lesser number. Congress recognized that some states were already making progress in the introduction of local competition, and it sought to permit that progress to continue. Consistent with the statute, the rules we promulgate today will enable those states in the vanguard to continue on their procompetitive course. Other states are being given the tools necessary to accelerate their progress. All states will have considerable responsibility for effectuating the transition to competition within their own borders.

Our decisions in this proceeding are the product of extensive discussions with state regulators concerning a wide variety of legal, economic, policy, and practical issues. The insights that have been shared with us by state regulators have guided us throughout our deliberations. Maintaining a successful partnership between state and federal regulators will be essential to fulfill the legislative expectations underlying the new structure set out in Sections 251 and 252 of the 1996 Act.

Out duty is to establish rules that are procompetition, not pro-competitor. Competitive access providers, cable companies, interexchange carriers, wireless companies, and others will all bring unique skills and strategies to the new competitive arena. Today's ruling, and the decisions that will follow from the state commissions, will enable all of these entities to compete robustly, and without hindrance based on other entities' entrenched market power.

In today's order, we are also facilitating new entry by identifying a core set of unbundled network elements that new entrants may obtain, singly or in combination, from incumbent LECs, to create new and innovative services. We send correct economic signals to potential entrants by requiring the use of forward-looking pricing principles. We promote voluntary negotiations by establishing minimal rules regarding the duty to bargain in good faith. We are providing immediate relief from CMRS-LEC interconnection agreements that violate fair play and flout our existing rules. In these and other respects, we act forcefully to bring to the local telephone market the dramatic change Congress intended.

Yet we also maintain fair treatment to the incumbent local exchange carriers. They are entitled to fair prices for the services and elements they offer, and our pricing principles accordingly reject costing methods that ignore the LECs' current network architecture or deny recovery of reasonable joint and common costs. The special needs of smaller incumbents, especially rural telcos, must be addressed with extra care, and just as Congress intended, we safeguard them today.

Some have expressed concern about the effect on universal service of flash-cut changes in market rules and pricing principles. We have listened -- and responded. With an abundance of caution, we have established an access charge transition of limited duration that will reduce the exposure of incumbent local exchange carriers to the sudden loss of access charge revenues. But we have also established for the long-term the principle that prices for network elements, transport and termination, and collocation must be based on costs -- not hidden subsidies that distort market forces.

We have committed to expeditious completion of the universal service proceeding, where we must make subsidies explicit and both eligibility and funding must become competitively neutral. On a parallel track, we must complete reform of access charges, to eliminate uneconomic incentives that distort investment decisions. A rational economic structure for all services and elements is vital to sustainable competition.

Only when the universal service, access reform, and interconnection rules are all in effect will local telephone subscribers really begin to see the full benefits of marketplace competition: lower prices, new services, and more choices. As market power wanes, the role of government will diminish as well.

Competition will take time to emerge. Expectations are high, but the reality will inevitably lag behind. As the process unfolds over the coming months and years, there are bound to be unforeseen circumstances, unintended consequences, and efforts to game the process. We will remain vigilant, and will reevaluate and refine our rules as necessary to promote competition that is both robust and fair.

Following the mandate of the Telecommunications Act of 1996, this Commission will not shrink from taking the steps necessary to enable the benefits of competition to reach consumers throughout the nation.

August 8, 1996

Separate Statement of

Commissioner Rachelle B. Chong

Re: In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers, CC Docket No. 95-185; Implementation of Sections 3(n) and 332 of the Communications Act, GN Docket No. 93-252.

The passage of the Telecommunications Act of 1996[1] marked the end of more than sixty years of monopoly style regulation. The changes wrought by the 1996 Act on the telephone industry are dramatic and comprehensive. I write separately to emphasize my strong belief that the pro-competitive path we have unanimously chosen in this interconnection order is the right one.

On the day the 1996 Act became law, the Commission embarked on a challenging journey to help implement the new statute. Our final destination has been clearly delineated by Congress. We are "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition."[2]

True to this charge, we have resolved to act quickly and decisively to open all telecommunications markets to competition, to provide pricing methodologies that will drive rates toward cost, and to provide a national policy framework that will achieve this restructuring of the industry in an orderly and efficient manner. The rules in this item do not favor any particular industry or player over another, but instead free them from outdated regulatory restraints in order to compete with each other.

The 1996 Act opens up the local telephone network to competitors, and provides them with unprecedented access through an interconnection framework.[3] The Act provides three

---

1 Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 *to be codified at* 47 U.S.C. §§ 151 *et. seq.* (1996 Act).

2 S. Conf. Rep. No. 104-230, 104th Cong., 2d Sess. 1 (1996).

3 Interconnection refers to the physical linking of two networks for the mutual exchange of traffic.

methods of entry through which a competitor may enter the local telephone market: (1) full facilities-based entry; (2) purchase of unbundled elements from the incumbent local exchange carrier (LEC), i.e. network "piece parts;" and (3) resale, which gives a competitor the ability to purchase an incumbent LEC's retail service at a wholesale price and repackage it for sale to the competitor's own end user.

Facilities-based Competition. The first entry option -- facilities-based competition -- represents the most dramatic departure from our current bottleneck monopoly structure. A full facilities-based competitor would offer a myriad of distinct services through separate facilities to its subscribers, and thus providing consumers with the benefits of head-to-head competition. As a practical matter, however, we do not expect a market typified by full-fledged facilities-based competition to blossom overnight. These networks or systems must be planned, financed and constructed over time. As a result, the other two entry avenues -- the purchase of unbundled elements and resale -- take on a special importance in the near term to bring swift competition to the local marketplace.

Unbundled Elements. Some new entrants already have some network infrastructure in place, and lack only a few critical components in order to provide local exchange service to consumers. For example, today's cable operators have a coaxial wire that passes over 96.6% of the TV households in America.[4] If a cable operator can access the remaining necessary network elements from the incumbent LEC, the cable operator would be only a step away from providing local telephone service over its upgraded network. This example points out why it is essential for new entrants to obtain access to those network piece parts. In our order, we set forth a minimum list of unbundled network elements that incumbent LECs uniformly must make available to new entrants upon request. The state commissions may expand upon this list. We believe that this action will give new entrants what they need so competition is "jump started."

Resale. Resale is another critically important entry strategy because three types of new entrants stand to benefit. First, facilities-based competitors that want to immediately enter the market prior to completing their own networks can use resale as a transition mechanism. Second, facilities-based competitors whose existing infrastructure does not overlap the incumbent LEC's service area, may choose to use resale to ensure that it can offer a competing local service package within the same service territory as the incumbent LEC. Third, new entrants who do not intend to offer facilities-based competition will be able to compete immediately in the local market by purchasing discounted services of the incumbent LEC. For all of these categories, our decision provides a viable avenue for immediate market entry.

Free Market Negotiations. I highlight that the 1996 Act has made the mechanism for entry a *free market* negotiation process between the incumbent LEC and any potential new

---

[4] Paul Kagan Associates, Inc., *Marketing New Media*, Mar. 18, 1996.

competitor. Under Section 252(a)(1), the Commission's Section 251 rules play no role if an incumbent LEC and a new entrant reach a purely voluntary agreement, and the state commission approves it through the process set forth in Section 252.

Need for Minimum National Baselines. It is only if the carriers are unsuccessful in their voluntary negotiations that government steps in. The Act provides that the state commissions arbitrate the disputes. In today's order, we set forth a baseline of terms and conditions for an arbitrated interconnection agreement. I support this action for three reasons. First, because interconnection matters are very complex and technical, I believe that minimum national guidelines will help parties lower their transaction costs and will help drive them to reach their voluntary agreements much faster. At the outset of their voluntary negotiations, parties will understand what their minimum rights will be in a subsequent state commission arbitration process; it is our hope this may encourage earlier agreement.

Second, a baseline of terms and conditions simplifies the state commission arbitration process. A baseline enables a state commission to quickly approve an agreement and thus rapidly introduce competition. The presence of a baseline minimizes any regulatory delay that might result if a state commission were to establish from scratch its own pricing methodology or conduct a proceeding to identify network elements that must be unbundled.

Third, in establishing some national minimum baselines, we greatly aid new entrants who have national or regional strategies. Without such baselines, these competitors would face a "patchwork quilt" of differing state regulatory requirements that may create a potential entry barrier by increasing their entry costs and causing substantial delay. Thus, it is my view that these baselines promote swift competitive entry, which in turn will lead to the earlier introduction of competitive services to consumers.

Access Charge Transition. Although we take a great leap forward toward competition with this interconnection order, our goal in making local telephone competition a reality will not be complete until we finish universal service reform and restructure our current access charge regime. Our order notes that the Act sets forth a specific time frame by which the Commission must issue final rules as to interconnection (August 1996) and universal service reform (May 1997). Because of the time differential between these dates, and in order to avoid undue disruption of the incumbent LECs' ability to support universal service, I have supported our decision to require new entrants when purchasing unbundled elements to pay a portion of certain access charges until no later than June 30, 1997. My support for the establishment of a short term access charge transition scheme is premised on the Commission's firm commitment to complete universal service and access charge reform by the first half of 1997. I underscore my determination that the interim access charge mechanism proposed herein is of a finite duration. I can foresee no circumstance upon which it would be extended beyond the dates set forth in our order.

Pricing Methodology. Prices of interconnection and unbundled elements, along with prices for transport and termination and resale, are all crucial to any interconnection

agreement. Again, should the parties voluntarily agree on such prices, these agreements will be submitted to the states for approval and there is no government intervention in the process.

If carriers cannot agree, however, today's decision makes clear that the FCC will *not* set these prices. The Act provides that the appropriate state commission will step in to set prices. To help guide state commissions as they set prices according to local conditions, we have established methodological pricing principles that are consistent with the Act's cost-based pricing provisions. We have asked the state commissions to use the cost-based pricing methodology described in our order when they conduct an economic cost study to set their state specific rates. A clear benefit of this approach is that such a national framework will encourage the swift establishment of a common, pro-competition understanding of pricing principles among the states.

We also have established certain default proxies that states will use in the interim, if they have not completed a cost study during an arbitration, or if they lack the necessary resources to initiate their own cost study. It is my view that these default proxies, which are either price ceilings or price ranges, will greatly speed competition. For example, in a situation where the state commission has not yet completed a cost study but must render a decision on specific pricing issues in an arbitration pursuant to the deadline imposed by Section 252(e)(4), the default proxies will assist the state commission in resolving the pricing issues quickly and in a way consistent with the Act's cost-based pricing principles.

I emphasize that a state commission has the flexibility to set a specific rate that is either above or below the default proxy ceiling or range if it has conducted its own cost study consistent with the pricing methodology set forth in our order. The default proxy is only an interim mechanism and it may not be relied upon once a state commission has completed its own economic cost study.[5]

CMRS-LEC Interconnection Issues. In our order, I have supported our decision to allow CMRS-LEC interconnection matters to be governed by the Sections 251/252 provisions, while continuing to acknowledge our continuing jurisdiction pursuant to Section 332 over CMRS-LEC interconnection matters. In doing so, we have declined to opine on the precise extent of our Section 332 jurisdiction over CMRS-LEC interconnection matters, however. I emphasize that by opting to use the Section 251/252 framework, we are not repealing our Section 332 jurisdiction by implication or rejecting Section 332 as an alternative basis for jurisdiction.

---

[5] It is unfortunate that we did not have enough of a record in this proceeding to decide what would be an appropriate proxy for paging carriers' termination costs or to set a default proxy. I am committed to moving forward with a further rulemaking proceeding on this issue as quickly as possible.

While we have generally crafted our interconnection rules not to favor any particular industry, player or technology over another, we cannot shut our eyes to inherent differences between some classes of carriers' services that may pose potential problems when we seek to apply our new interconnection rules. I believe that should the need arise in the future, we should not hesitate to adapt some of our general interconnection rules to recognize the unique nature of particular classes of service providers, such as CMRS providers. It is for this reason that I supported the Commission's decision to reserve its right to exercise jurisdiction over LEC-CMRS interconnection under Section 332.

There are several differences that set wireless CMRS providers apart from some of the other telecommunications carriers that will avail themselves of the Sections 251 and 252 interconnection framework. First, when adopting Section 332 in 1993, Congress created a national regulatory framework for CMRS providers, and granted the FCC authority to preempt states from entry and rate regulation. Congress made clear that its intent was to "foster the growth and development of mobile services that, by their nature, operate without regard to state lines as an integral part of the national telecommunications infrastructure."[6] This recognition that CMRS services are uniquely interstate in scope was apt. CMRS service areas, which are established federally, can encompass more than one state jurisdiction.[7] Congress was rightly concerned that imposing multiple state regulatory schemes on CMRS providers may prove unduly burdensome, cause delay, and otherwise inhibit the industry's growth. Notably, Congress did not repeal Section 332 when it provided new Sections 251 and 252 in the 1996 Act.

Second, CMRS providers have suffered past discrimination at the hand of the LECs and by certain state commissions with regard to interconnection matters. Today's record is replete with examples of LECs that have significantly overcharged CMRS providers for past interconnection. Further, in violation of our rules, our record reflects that in some cases, LECs have refused to pay CMRS providers for calls terminated by LECs on the CMRS networks, while other wireline carriers have received such compensation from the LECs. In

---

[6] H.R. Report No. 103-11, 103rd Cong., 1st Sess. 260 (1993).

[7] For example, Personal Communications Service (PCS) providers in the Washington - Baltimore Major Trading Area (MTA) are subject to six jurisdictions -- Pennsylvania, Delaware, Maryland, Virginia, West Virginia and the District of Columbia -- due to the large size and location of the federally set service areas. Should one of these PCS providers need to arbitrate an interconnection agreement pursuant to Section 251 and 252, such PCS provider could be subjected to as many as *six* state arbitration proceedings. This scenario could impose undue burdens, such as increased transaction costs, regulatory delay, and the potential for inconsistent results, for CMRS providers with interstate service areas. For this reason, we reserve our right to in the future to use Section 332 as an alternative basis for jurisdiction over CMRS providers faced with this type of a dilemma.

other instances, LECs have required certain CMRS providers to pay for the traffic the LEC carrier originates and terminates on the systems of the CMRS provider. These problems have been compounded by certain state commissions who have limited access by CMRS providers to more reasonable interconnection rates afforded by LECs to other wireline carriers.

In this order, we have taken a variety of measures to remedy this discrimination and to ensure that CMRS providers are placed on an even footing with other telecommunications carriers when obtaining LEC interconnection. I am particularly pleased that we will allow CMRS providers with current interconnection agreements that provide for non-mutual compensation an opportunity to renegotiate those agreements under the framework of Sections 251/252, without incurring any early termination penalties. In light of the past discrimination CMRS providers have experienced, however, I would have taken two additional steps.

First, I would have extended the "fresh look" opportunity to all CMRS providers -- not just those with non-mutual compensation arrangements. Our decision was to limit relief in this instance to contracts that are clearly unlawful because they violate Section 20.11 of our rules. Section 20.11, however, requires not only that CMRS-LEC interconnection agreements comply with principles of mutual compensation, but also that each carrier pay *reasonable* compensation. I believe that the record in this proceeding clearly demonstrates that the rates the LECs have charged CMRS providers have far exceeded their costs and thus could not fairly be characterized as "reasonable" compensation.

Second, instead of requiring the CMRS providers to continue paying their current interconnection rates, I would have permitted CMRS providers to immediately begin paying the default proxy rate while their interconnection arrangements were being renegotiated.

It is my hope that on a going-forward basis, CMRS providers will be able to obtain fair, reasonable and non-discriminatory interconnection rates under the terms of today's decision. For reasons of simplicity and regulatory parity, it makes sense to me to have a single regulatory scheme pursuant to Sections 251 and 252 apply as to all incumbent LEC interconnection matters. Bearing in mind Congress' concerns about the interstate nature of the CMRS industry, however, I have concerns that the state-by-state arbitration process may pose undue burdens on, or otherwise hinder the growth of, the CMRS industry. If it does, I would not hesitate to invoke our Section 332 jurisdiction if I believe that the framework we impose today is having adverse impacts on the CMRS industry.

16253 •U.S. GOVERNMENT PRINTING OFFICE: 1997-417-484/60009

No. 00-511

Supreme Court, U.S.
FILED
APR 9 2001
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,*
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR PETITIONERS

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1650 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

April 9, 2001

Additional Counsel Listed on Inside Cover

* The full list of Petitioners is set forth in the List of Parties *infra* p. ii.

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 South Grand Avenue
Los Angeles, CA 90071
(213) 683-9100

Counsel for Verizon Entities

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, TX 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 Eye Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States
Telecom Association

QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

LIST OF PARTIES AND RULE 29.6 STATEMENT

The Petitioners in this Court are:

Verizon Entities, consisting of:

Verizon Communications Inc.
GTE Service Corporation
GTE Alaska Incorporated
GTE Arkansas Incorporated
Verizon California Inc. (f/k/a GTE California Incorporated)
Verizon Florida Inc. (f/k/a GTE Florida Incorporated)
GTE Midwest Incorporated
Verizon South Inc. (f/k/a GTE South Incorporated)
GTE Southwest Incorporated
Verizon North Inc. (f/k/a GTE North Incorporated)
Verizon Northwest Inc. (f/k/a GTE Northwest Incorporated)
Verizon Hawaii Inc. (f/k/a GTE Hawaiian Telephone Company Incorporated)
Verizon West Coast Inc. (f/k/a GTE West Coast Incorporated)
Contel of Minnesota, Inc.
Contel of the South, Inc.

BellSouth Corporation
SBC Communications Inc.
United States Telecom Association

The parties to the proceedings in the Eighth Circuit are listed in the caption of the decision below, *see* Appendix A to the Petition for Writ of Certiorari, and in Appendix F to the Petition for a Writ of Certiorari.

Pursuant to Supreme Court Rule 29.6, Petitioners state as follows:

On June 30, 2000, GTE Corporation and Bell Atlantic Corporation closed their merger, and Bell Atlantic Corporation subsequently changed its name to Verizon Communications Inc. Verizon Communications Inc. is the ultimate parent of each of the other Verizon Entities listed above. No publicly

owned company owns 10% or more of the stock of Verizon Communications Inc.

SBC Communications Inc. has no parent company, and no publicly owned company owns more than 10% of its stock.

BellSouth Corporation has no parent company, and no publicly owned company owns more than 10% of its stock.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

LIST OF PARTIES AND RULE 29.6 STATEMENT ii

TABLE OF CONTENTS iv

TABLE OF AUTHORITIES vi

INTRODUCTION 1

OPINIONS AND ORDERS BELOW 1

JURISDICTION 2

PERTINENT CONSTITUTIONAL AND STATUTORY PROVISIONS 2

STATEMENT 2

A. The Regulatory Background Prior to 1996 2

B. The Telecommunications Act of 1996 5

C. The FCC's Local Competition Order 8

D. Judicial Review 14

SUMMARY OF ARGUMENT 16

ARGUMENT 19

I. SECTION 252(d)(1) REQUIRES USE OF HISTORICAL COSTS FOR NETWORK-ELEMENT PRICES 19

II. UNDER CONSTITUTIONAL PRINCIPLES, SECTION 252 CANNOT BE CONSTRUED TO AUTHORIZE TELRIC 23

A. Section 252 Mandates a Pricing Methodology Designed To Provide Constitutional Compensation 24

B. TELRIC Violates Section 252(d)(1) Because It Shifts Methodologies Without Providing for Recovery of Past Prudent Investment 26

C. The FCC's Efforts To Deflect Scrutiny from the Constitutional Defects in TELRIC Are Meritless 31

1. Under the "total effect" test, TELRIC's deficiencies cannot be cured by looking to revenues earned from *all* of an incumbent's operations 32

2. TELRIC must be evaluated now as a final agency action that is contrary to the Act 37

D. Section 252(d)(1) Should Be Construed To Avoid the Serious Constitutional Questions TELRIC Raises 42

III. THE FCC'S DECISION TO ABANDON HISTORICAL COSTS WAS CONTRARY TO THE PURPOSES OF THE ACT AND ARBITRARY AND CAPRICIOUS 44

A. Abandoning Historical Costs Frustrated Congressional Objectives and Was Not Supported By Any Rational Explanation 44

B. The FCC's Effort To "Mimic" Competitive Outcomes Frustrates the Purposes of the Act . 48

CONCLUSION 50

TABLE OF AUTHORITIES

Cases — **Page(s)**

Ashwander v. Tennessee Valley Auth.,
297 U.S. 288 (1936) 42

AT&T Corp. v. Iowa Utils. Bd.,
525 U.S. 366 (1999) 2, 5, 8, 13, 15, 19, 36, 46, 48

Bell Atlantic Tel. Cos. v. FCC,
24 F.3d 1441 (D.C. Cir. 1994) 25, 44

Bennett v. Spear,
520 U.S. 154 (1997) 21

Brooks-Scanlon Co. v. Railroad Comm'n,
251 U.S. 396 (1920) 18, 33

Calfarm Ins. Co. v. Deukmejian,
771 P.2d 1247 (Cal. 1989) 35

California Dental Ass'n v. FTC,
526 U.S. 756 (1999) 21

Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,
467 U.S. 837 (1984) 16, 23, 26

Chicago, M. & St. P. Ry. v. Public Utils. Comm'n,
274 U.S. 344 (1927) 34

Corning Glass Works v. Brennan,
417 U.S. 188 (1974) 20

Duquesne Light Co. v. Barasch,
488 U.S. 299 (1989) 3, 17, 25, 27, 28, 34, 38, 42

Eastern Enters. v. Apfel,
524 U.S. 498 (1998) 17, 30

Federal Power Comm'n v. Hope Natural Gas Co.,
320 U.S. 591 (1944) 2, 26, 38

Federal Power Comm'n v. Natural Gas Pipeline Co.,
315 U.S. 575 (1942) 24, 38

Gomez v. United States,
490 U.S. 858 (1989) 18, 42

GTE South Inc. v. Morrison,
199 F.3d 733 (4th Cir. 1999) 41

Gustafson v. Alloyd Co.,
513 U.S. 561 (1995) 23

In re Permian Basin Area Rate Cases,
390 U.S. 747 (1968) 24, 38

Iowa Utils. Bd. v. FCC,
120 F.3d 753 (8th Cir. 1997) 15

Jersey Cent. Power & Light Co. v. FERC,
810 F.2d 1168 (D.C. Cir. 1987) 38

Kaiser Aetna v. United States,
444 U.S. 164 (1979) 17, 30

Legal Servs. Corp. v. Velazquez,
121 S. Ct. 1043 (2001) 42

McDermott Int'l, Inc. v. Wilander,
498 U.S. 337 (1991) 20

Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n,
262 U.S. 276 (1923) 3, 45

Monongahela Navigation Co. v. United States,
148 U.S. 312 (1893) 26

Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.,
463 U.S. 29 (1983) 46

NLRB v. Catholic Bishop,
440 U.S. 490 (1979) 18, 43

Ohio Bell Tel. Co. v. Public Utils. Comm'n.,
301 U.S. 292 (1937) 22

Pennsylvania Coal Co. v. Mahon,
260 U.S. 393 (1922) 27

Phelps v. United States,
274 U.S. 341 (1927) 25

Presault v. ICC,
494 U.S. 1 (1990) 38

Smith v. Illinois Bell Tel. Co.,
282 U.S. 133 (1930) 18, 34

Solid Waste Agency v. U.S. Army Corps of Eng'rs,
121 S. Ct. 675 (2001) 18, 23, 43

United States v. Menasche,
348 U.S. 528 (1955) 21

United States v. Riverside Bayview Homes, Inc.,
474 U.S. 121 (1985) 43, 44

United States v. Security Indus. Bank,
459 U.S. 70 (1982) 17, 43

United States v. Winstar Corp.,
518 U.S. 839 (1996) 30

USTA v. FCC,
188 F.3d 521 (D.C. Cir. 1999) 3

West v. Chesapeake & Potomac Tel. Co.,
295 U.S. 662 (1935) 22, 38, 47

Constitutional Provisions and Statutes

Takings Clause, U.S. Const. amend. V 2
28 U.S.C. § 1254(1) 2
28 U.S.C. § 2342(1) 2
47 U.S.C. § 251 2
47 U.S.C. § 251(c)(2) 6
47 U.S.C. § 251(c)(3) 7
47 U.S.C. § 251(c)(4) 6
47 U.S.C. § 251(d)(1) 22, 46
47 U.S.C. § 251(d)(2) 7
47 U.S.C. § 252 ..... 2, 32
47 U.S.C. § 252(a) 11
47 U.S.C. § 252(b) 11
47 U.S.C. § 252(b)(1) 46
47 U.S.C. § 252(d)(1) .. 1, 16, 18-20, 22, 24-26, 40, 42, 50
47 U.S.C. § 252(d)(1)(A) 7, 21
47 U.S.C. § 252(d)(1)(B) 7, 20, 21
47 U.S.C. § 252(e)(4) 46
47 U.S.C. § 253(a) 6
47 U.S.C. § 254(a)(2) 8
47 U.S.C. § 254(b)(5) 7
47 U.S.C. § 254(d) 35
47 U.S.C. § 254(e) 35
47 U.S.C. § 402(a) 2

Regulations

47 C.F.R. § 51.505(d)(1) 40
47 C.F.R. §§ 51.501-51.511 2

Administrative Agency Orders

Bottleneck Servs. Establishment of a Framework for Network Architecture Development of Dominant Carrier Networks, Slip Op., R.93-04-003, I.93-04-002, Dec. 95-12-016, 62 CPUC2d 575 (Cal. PUC Dec. 6, 1995) 46

Federal-State Joint Board on Universal Service, Fifth Report & Order, 13 F.C.C.R. 21,323 (1998) 13, 45

Federal-State Joint Board on Universal Service, Ninth Report & Order, 14 F.C.C.R. 20432 (1999) 46

FERC Order No. 888, 61 Fed. Reg. 21,540 (1996) 12

In re Access Charge Reform, 12 F.C.C.R. 15,982 (1997) 4, 12

In re Federal-State Joint Board on Universal Service, CC Docket No. 96-45, 12 F.C.C.R. 8776 (1997) 9, 12, 13, 36, 45

In re Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report & Order and Further Notice of Proposed Rulemaking, 9 F.C.C.R. 4527 (1994) 20, 45

In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report & Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (Nov. 5, 1999) 15

In re Price Cap Performance Review for Local Exchange Carriers, Fourth Report & Order, 12 F.C.C.R. 16,642 (1997), *rev'd in part, USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999) 47

Proceeding on Motion of the Comm'n To Examine N.Y. Tel. Co.'s Rates for Unbundled Network Elements, N.Y. Pub. Serv. Comm'n Case No. 98-C-1357 14

Promotion of Competitive Networks in Local Telecommunications Markets, Notice of Proposed Rulemaking, FCC No. 99-141, 14 F.C.C.R. 12,673 (July 7, 1999) 6

Proposed Rules Regarding Implementation of §§ 40-15-101 et seq. - Requirements Relating to Interconnection and Unbundling, Decision Adopting Rules, Docket No. 95R-556T, Decision No. C96-347 (Colo. PUC Mar. 29, 1996) 47

Report & Order, *In re Federal-State Joint Board on Universal Service*, 12 F.C.C.R. 8776 (1997) 4

Legislative Materials

H.R. Rep. No. 104-204 (1995) 7, 23

H.R. Rep. No. 104-458 (1996) 5, 6

Hearing Before the Antitrust Subcomm. of the Senate Judiciary Comm., 1999 WL 8084924 (Feb. 25, 1999) (statement of Joel I. Klein, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice) 14

Texts and Treatises

William J. Baumol & J. Gregory Sidak, *Stranded Costs*, 18 Harv. J.L. & Pub. Pol'y 835 (1995) 49

Black's Law Dictionary (6th ed. 1990) 19

James C. Bonbright *et al.*, *Principles of Public Utility Rates* (2nd ed. 1988) 19, 44

Hon. Stephen Breyer, *Regulation and Its Reform* (1982) 20, 45

P. Huber, M. Kellogg & J. Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry* 5

Reed Hundt, *You Say You Want a Revolution* (2000) 8

Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation, or: Temptation of the Kleptocrats and the Political Economy of Regulatory Disingenuousness* (1998) 4

Webster's Third New International Dictionary (1993) 19

Miscellaneous

1999 Statistics of Communications Common Carriers (Aug. 11, 2000) 11

Accounting Policy Division, Common Carrier Bureau, FCC, Hybrid Cost Proxy Model, Version 2.6, Revised Model Results: Wirecenter Support Spreadsheet (Jan. 20, 2000) <http://www.fcc.gov/ccb/apd/hcpm/wcsupport.xls> ... 11

C. Michael Armstrong, *Break Up the Baby Bells!*, Wall St. J., Mar. 28, 2001 14

Brief for FCC & U.S., *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) (No. 97-831) 41

Brief for FCC, *Texas Office of Pub. Utils. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999) (No. 97-60421) 4

Comments of MCI Telecomms. Corp., in *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 16, 1996) 9

Comments of the United States Tel. Ass'n, *In re Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262, *et al.* (filed Jan. 29, 1997) 4

Connecticut Research, 1995/96 Local Telecommunications Competition (7th ed. 1995) 5

Council of Economic Advisors, 1996 Economic Report of the President (GPO 1996) 12

Declaration of Alfred E. Kahn and Timothy J. Tardiff, submitted with Reply Comments of Bell Atlantic, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 30, 1996) 49

Reed Hundt, FCC Chairman, Antitrust and Interconnection: Old Wine in New Bottles, Remarks at Antitrust Conf. for Corp. General Counsels, 1996 WL 646783 (Nov. 8, 1996) 6

John J. Keller, *Ringing Bell: AT&T's New President Is Wasting No Time in Shaking Things Up*, Wall St. J., Dec. 24, 1996 13

Merrill Lynch, MFS Communications (Nov. 7, 1996) 13

Supplemental Aff. of Dennis B. Trimble, in Appendix to GTE Service Corp.'s Motion for Stay Pending Judicial Review and for Expedited Judicial Review, *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) (No. 96-3321) 10

Testimony of Dennis B. Trimble, GTE Corp., *In re Petitions of AT&T Communications, et al., for Arbitration of Unresolved Issues from Interconnection Negotiations with GTE South, Inc. Pursuant to § 252 of the Telecommunications Act of 1996*, Virginia State Corp. Comm'n Case Nos. PUC960117, et al. (Nov. 21, 1996) 10

Transcript, "AT&T Investment Community Meeting" (Mar. 3, 1997) 13

INTRODUCTION

The local telephone network represents one of the largest private capital investments in this country. This massive investment was induced by a regulatory regime that offered shareholders the opportunity to recover prudent investment plus a reasonable return through retail telephone rates. The Telecommunications Act of 1996 gives competitors the right to exclusive use of portions of that network to provide their own telephone service. At the same time, the Act mandates that "just and reasonable" rates be established for this new use, and further specifies that these rates must recover "the cost . . . of providing" the network element and "may include a reasonable profit." 47 U.S.C. § 252(d)(1). The Act creates a new wholesale market for network elements and provides a mechanism whereby the competitors who profit from using these elements must fully compensate the incumbent owners.

The FCC has now declared that "the cost" of providing ongoing use of this capital-intensive network cannot include any recovery of past capital investment. The FCC has thus rewritten "cost" to mean "value," and has equated value with its own speculation as to what it might cost to provide a hypothetical network that is continuously updated with instantaneous and ubiquitous deployment of the most up-to-date technology in an optimally efficient design. With a stroke of the regulatory pen, the FCC has decreed that the existing network is worth about half of what it was the day before. The FCC's action results in systematic undercompensation of incumbent carriers for the network elements they are compelled to provide competitors. It contravenes the text and purpose of the statute and the constitutional standard of just compensation incorporated in it.

OPINIONS AND ORDERS BELOW

The court of appeals' decision is reported at 219 F.3d 744, and is reprinted in the appendix to the petition for certiorari ("Pet. App.") at pages 1a-43a. The Local Competition Order, *In re Implementation of the Local Competition Provisions of*

the Telecommunications Act of 1996, First Report and Order, is reported at 11 F.C.C.R. 15,499.

JURISDICTION

The court of appeals had jurisdiction pursuant to 28 U.S.C. § 2342(1) and 47 U.S.C. § 402(a). The Eighth Circuit issued its opinion and judgment on July 18, 2000. Petitioners timely filed a petition for certiorari on October 4, 2000. This Court has jurisdiction under 28 U.S.C. § 1254(1).

PERTINENT CONSTITUTIONAL AND STATUTORY PROVISIONS

This case involves the Takings Clause, U.S. Const. amend. V ("nor shall private property be taken for public use without just compensation"); sections 251 and 252 of the Telecommunications Act of 1996, 47 U.S.C. §§ 251, 252; 5 U.S.C. § 706; and 47 C.F.R. §§ 51.501-51.511. The statutory provisions are reproduced in the appendix to this brief.

STATEMENT

A. The Regulatory Background Prior to 1996

For most of the twentieth century, local telephone service was treated as a natural monopoly and was provided under a system of exclusive local franchises. Typically, a State granted a single company (now known as the incumbent local exchange carrier or incumbent "LEC") an exclusive franchise to provide local telephone service within a designated area. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). The incumbent was required to serve all customers within its service area and to make the massive investments necessary to satisfy this and other service mandates. For their part, regulators set retail rates designed to ensure that the incumbent had an opportunity to recover its costs plus a reasonable rate of return, as required by the Constitution. *See, e.g., Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 601-04 (1944).

Because the local network carries both intrastate and interstate calls, part of the cost of the local network has always been allocated to the federal jurisdiction, and the Federal Communications Commission ("FCC") has set charges associated with interstate calls sufficient to recover those costs. Thus, for decades state and federal regulators have been responsible for setting rates that allow incumbents to recover their costs and make a reasonable rate of return.

For over 60 years, both state and federal regulators have used cost-of-service ratemaking based on historical (or "embedded") costs to ensure adequate compensation. Under this method, regulators generally set rates to recover the full amount of prudently invested capital. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989). The theory behind this method is that the measure of value of the property dedicated to public use (and hence what the government must pay for) is not the value of the physical equipment, which might fluctuate over time, but rather the amount of capital invested, which is fixed once the investment is made. *See, e.g., Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., joined by Holmes, J., concurring).

In the years leading up to the 1996 Act, some States and the FCC began to adopt a modified version of historical cost ratemaking through a system known as "price caps." Under this system, an incumbent's current rates (which were set to recover historical costs) are taken as a starting point and are adjusted downward each year by a factor reflecting expected productivity gains (and typically are adjusted upward to reflect an inflation index). *See generally USTA v. FCC*, 188 F.3d 521, 524 (D.C. Cir. 1999). By determining rates through these adjustments, which place "caps" on prices, this system eliminates the need to redetermine periodically a carrier's costs. Nevertheless, because the system uses rates designed to recover historical costs as its baseline and modifies them to reflect

productivity gains based on actual industry data, it still provides incumbents an opportunity to recover historical costs. *See In re Access Charge Reform*, 12 F.C.C.R. 15,982, ¶ 27 (1997); Brief for FCC at 8-9, *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999) (No. 97-60421).

Regulators have also used their control over incumbents' rates to pursue a social policy known as "universal service." To ensure that all Americans receive basic telephone service at affordable rates, regulators set rates for residential and rural customers substantially below cost. They then set rates for business and urban customers well above cost to subsidize the below-cost rates. *See* Report & Order, *In re Federal-State Joint Board on Universal Service*, 12 F.C.C.R. 8776, 8784 ¶ 11 (1997) (hereinafter "Universal Service Order"). These implicit cross-subsidies have created lopsided markets in which incumbents often served the bulk of customers below cost while relying on a narrow segment to make up the difference.

A second way in which regulators kept basic rates low was by extending the depreciation lives of incumbents' equipment. By ignoring the economic lives of assets, regulators could reduce costs to be recovered in current rates by pushing recovery into the future. As a result, as the FCC has admitted, incumbents accumulated significant "depreciation reserve deficiencies" on their books, reflecting that the undepreciated value of some equipment exceeds its economic value.[1]

[1] *See* J.A. 364-65 (¶ 659 n.1633); *see also* Comments of the United States Tel. Ass'n at 74, *In re Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262, *et al.* (filed Jan. 29, 1997) (estimating depreciation reserve deficiency for large LECs at $17.9 billion); Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation, or: Temptation of the Kleptocrats and the Political Economy of Regulatory Disingenuousness* 7-8 (1998) (describing the "grossly inadequate" depreciation rates set for incumbents).

The exclusive franchise was central to this regulatory regime. Only by restricting competitive entry could regulators ensure that the extra margin built into the rates of "high-value" customers would actually flow to the incumbent serving other customers below cost. If competition were allowed, implicit subsidies would become subsidies for new entrants – those entrants would "cream skim" away high-margin customers, pocket the margin, avoid serving high-cost customers, and "leave the incumbents holding the bag for universal service." *AT&T Corp.*, 525 U.S. at 393.

B. The Telecommunications Act of 1996

The Telecommunications Act of 1996 (the "Act") was prompted by a growing recognition that alternative facilities and technologies were emerging that would make competition possible among multiple providers of local telephone service. These alternative systems included cable networks that could be upgraded for providing telephony, fiber networks in urban centers, and fixed wireless loops.[2] The premise of the Act was that the local market was no longer a natural monopoly and that more than one firm could efficiently provide local service. *See AT&T Corp.*, 525 U.S. at 371-72.

[2] *See, e.g.*, H.R. Rep. No. 104-458, at 148 (1996) (cable service is available to 95% of American homes and "[s]ome of the initial forays of cable companies into the field of local telephony therefore hold the promise of providing the sort of local residential competition that has consistently been contemplated"); Connecticut Research, 1995/96 Local Telecommunications Competition, at IV-2 (7th ed. 1995) ("Cable TV providers, long distance companies, and the new C-LECs . . . were all announcing plans to offer a pretty full array of telecommunications services to almost all classes of telecommunications customers."); P. Huber, M. Kellogg & J. Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry* 2.54 ("The cable industry is now moving fast toward two-way capabilities and a head-on challenge to the telephone's hegemony in two-way communications.").

The purpose of the Act, therefore, was to encourage the development of this emerging facilities-based competition. Congress explicitly proceeded on the assumption that "meaningful facilities-based competition is possible," H.R. Rep. No. 104-458, at 148 (1996), and intended the "opening [of] all telecommunications markets to competition" to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services," *id.* at 113. The FCC has acknowledged that the "most substantial benefits to consumers" promised by the Act "will be achieved through facilities-based competition." *Promotion of Competitive Networks in Local Telecommunications Markets*, Notice of Proposed Rulemaking, FCC No. 99-141, 14 F.C.C.R. 12,673, ¶ 4 (1999).

To allow competition, the Act terminated the incumbents' exclusive franchise and prohibited other state-imposed barriers to entry. *See* 47 U.S.C. § 253(a). To further foster the development of facilities-based competition, the Act imposed three new duties on incumbents vis-à-vis their competitors.

First, the Act required each incumbent to allow other carriers to "interconnect" their facilities with the incumbent's network. *See id.* § 251(c)(2). That requirement ensured that entrants could achieve ubiquity (*i.e.*, the ability for their customers to call and be called by all telephone subscribers) without replicating the incumbent's entire network.

Second, Congress required incumbents to sell their retail services to new entrants at wholesale rates so that entrants could resell the services under their own brand names. *See id.* § 251(c)(4). Beyond just enabling "reseller" competition, this requirement was intended to foster facilities-based competition by allowing entrants to build sufficient scale to support investment in facilities.[3]

---

[3] *Cf.* Reed Hundt, FCC Chairman, Antitrust and Interconnection: Old Wine in New Bottles, Remarks at Antitrust Conf. for Corp. General Counsels, 1996 WL 646783 (Nov. 8, 1996) (resale was a "competitive stepping stone to facilities-based competition" in long distance markets).

Third, Congress required incumbents to provide competitors access to certain pieces of their networks, known as "unbundled network elements" or "UNEs." *See id.* § 251(c)(3). This requirement was intended to encourage the rapid deployment of new facilities by ensuring that new entrants could begin to compete even if they had only partial facilities and needed to rely in part on elements leased from the incumbent's network.

The incumbents' duty to provide UNEs is also subject to important restrictions. The Act directs the FCC to *limit* access to incumbents' UNEs to those elements that competitors genuinely need to obtain from the incumbent in order to compete. *See id.* § 251(d)(2). The Act also requires that incumbents be paid constitutionally sufficient compensation for forced uses of their property. The Act specifies that the prices for interconnection and UNEs shall be "just and reasonable," "shall be based on the cost . . . of providing the interconnection or network element," and "may include a reasonable profit." *Id.* § 252(d)(1)(A), (B). In addition, Congress used retail rates as the basis for wholesale prices, thereby preserving incumbents' ability to recover historical costs (which are reflected in retail rates). *See* H.R. Rep. No. 104-204, pt. 1, at 72 (1995) ("[I]t is the Committee's intent that there be a recognition of pricing structures for telephone exchange service in the State.").

Congress also recognized that, by abolishing the incumbents' exclusive franchises, it had made the old universal service system of implicit subsidies untenable. Congress therefore directed the FCC, after consultation with a Federal-State Joint Board, to establish new funding mechanisms that must be "specific, predictable and sufficient" to "preserve and advance universal service." 47 U.S.C. § 254(b)(5), (d). Congress also

demanded prompt action on these reforms and required the FCC to complete a proceeding to "implement the recommendations from the Joint Board" by May 1997. *Id.* § 254(a)(2).

C. The FCC's Local Competition Order

The FCC was dissatisfied with the 1996 Act. As then-Chairman Reed Hundt later admitted, the FCC thought the Act had not gone far enough to favor new entrants and was "tilted toward the local phone companies' advantage." Reed Hundt, *You Say You Want a Revolution* 154 (2000). Hundt believed that the FCC could use its "broad authority" in writing the implementing rules to change the balance struck in the Act: "like the modern engineers trying to straighten the Leaning Tower of Pisa, we could aspire to provide the new entrants to the local telephone markets a fairer chance to compete than they might find in any explicit provision of the law." *Id.*

On August 8, 1996, the FCC issued its Local Competition Order. Section 251 required the FCC to address two issues: (i) what parts of the network would be made available to entrants, and (ii) what the prices for those UNEs would be. On the first issue, as this Court has already determined, the FCC ignored the limiting standards set by Congress in section 251(d)(2). *See AT&T Corp.*, 525 U.S. at 387-92. Instead, the agency decreed virtually unlimited access to incumbents' networks. *See* J.A. 288, 292-94 (¶¶ 278, 286-287). The FCC thereby enabled an entrant to obtain, and resell, finished service through the fiction of buying a combined set of the incumbent's network elements – the so-called UNE platform or "UNE-P."

On pricing, the FCC categorically rejected incumbents' arguments that UNE prices should be set to allow incumbents the opportunity to recover historical costs. *See id.* at 375-76, 397-401 (¶¶ 672-673, 704-707). Instead, the FCC concluded that it should set prices by projecting the forward-looking costs of a hypothetical carrier that always uses throughout its

network only the most up-to-date technology deployed in the most efficient network configuration. *See id.* at 379-80, 382-84 (¶¶ 679, 683-685). The FCC dubbed the novel methodology it invented for projecting these costs "Total Element Long Run Incremental Cost" or "TELRIC." *Id.* at 378-79 (¶ 678). TELRIC's only concession to the reality of the existing network was that it assumed that wire centers would remain in the same location. *See id.* at 383-84 (¶ 685).

TELRIC completely ignores incumbents' past investments. The FCC's asserted justification for brushing aside these embedded costs was that incumbents were "inefficient" and that their historical costs would "reflect inefficient or obsolete network design and technology." *Id.* at 383 (¶ 684); *see also id.* at 375-76 (¶ 672); Universal Service Order ¶¶ 224-225, 228. And the FCC's express goal in adopting TELRIC was to produce dramatically *lower* prices than would be dictated by historical costs. *See* J.A. 399-400 (¶ 706) (historical costs would require "increasing the rates for interconnection and unbundled elements"); *id.* at 398-99 (¶ 705) (historical costs would favor incumbents by inflating prices). Indeed, potential entrants were clamoring for forward-looking costs precisely because they knew that the FCC's formula would produce substantially lower prices for UNEs. *See, e.g.*, *id.* at 340-42, 359-61 (¶¶ 635, 655); Comments of MCI Telecomms. Corp. at 63, 65, in *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 16, 1996) (prices using historical costs would be "higher than" prices using forward-looking costs; "rates based on historical costs are excessive").

The FCC ensured that TELRIC would yield lower prices by indulging in three assumptions that could not be met in any real-world market. *First*, TELRIC assumes that prices will always immediately reflect the costs of the most efficient technology and network configuration. *See* J.A. 383-84 (¶ 685). TELRIC thus hypothesizes a fantasy world in which carriers

would repeatedly rip out and instantaneously rebuild their entire plant every time a newer technology hits the market or a more efficient configuration could be achieved. The FCC has never disputed that such a fantasy carrier could never exist in reality, but it has nonetheless used this fiction to justify radical downward repricing of the existing network. *Second*, TELRIC contradictorily presumes that the economic depreciation rate for equipment would be the same as the extended depreciation rate used by regulators in the prior monopoly regime. *See id.* at 395-96 (¶ 702). *Third*, TELRIC similarly presumes that carriers in its fictional world of constant network replacement would nonetheless continue to have the same cost of capital established for incumbents in the stable, low-risk monopoly system of the past. *See id.* at 385-86, 395-96 (¶¶ 687-688, 702).

TELRIC had its intended effect: it produced massive price reductions from historical costs. The FCC itself set "proxy prices" that it said approximated TELRIC, and they resulted in 60% discounts from historical costs.[4] Moreover, the FCC *required* States to use those proxies until they had completed new TELRIC cost studies. *See* J.A. 326 (¶ 619). The FCC made clear that its proxies were *ceilings*. States could "select lower prices," but they were warned to provide justifications on the record "especially for setting a rate above a default proxy ceiling." *Id.* When state utility commissions began applying TELRIC, they typically produced discounts of 50% below historical cost.[5] Indeed, TELRIC projects that the entire local

[4] *See* Supplemental Aff. of Dennis B. Trimble, ¶¶ 17-18, in Appendix to GTE Service Corp.'s Motion for Stay Pending Judicial Review and for Expedited Judicial Review, *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) (No. 96-3321) (J.A. 462-63).

[5] *See, e.g.*, Testimony of Dennis B. Trimble, GTE Corp., in *In re Petitions of AT&T Communications, et al., for Arbitration of Unresolved Issues from Interconnection Negotiations with GTE South, Inc. Pursuant to § 252 of the Telecommunications Act of 1996*, Virginia State Corp. Comm'n Case Nos. PUC960117, *et al.*, Tr. 726-28 (Nov. 21, 1996).

exchange infrastructure throughout the country could be rebuilt for about $180 billion – roughly half the $342 billion actually invested in the existing infrastructure[6] and only six times the amount that incumbents pour into capital expenditures on the network *each year*.[7]

Nor does TELRIC effect only a one-time downward revaluation of the network. Rather, incumbents are subject to further downward repricing of the network each time an entrant seeking network elements requests an arbitration under the Act. *See* 47 U.S.C. § 252(a), (b). Thus, through TELRIC, all incumbents' past and future investments are continuously subject to retroactive reclassification as "inefficient" and hence unrecoverable.

The FCC categorically determined that historical costs should not be included in UNE prices. It stated that including those costs would "interfere" with its policy goal of optimizing "efficient" competition. J.A. 399-400 (¶ 706). The agency determined that incumbents were not entitled to recover historical costs, *see id.* at 375-76, 397-401 (¶¶ 672, 704-707), and that precluding their recovery would not be confiscatory, *see id.* at 418-23 (¶¶ 733-740). At the same time, the FCC vaguely hinted that it might consider addressing some stranded historical costs in a future proceeding – which it has never done. In the Local Competition Order, the FCC suggested that

[6] TELRIC projects that, on average, it costs $885 per line to construct a local exchange network, and the FCC has projected that there are roughly 202.9 million access lines in the country. *See* Accounting Policy Division, Common Carrier Bureau, FCC, Hybrid Cost Proxy Model, Version 2.6, Revised Model Results: Wirecenter Support Spreadsheet (Jan. 20, 2000) <http://www.fcc.gov/ccb/apd/hcpm/wcsupport.xls>. *Compare 1999 Statistics of Communications Common Carriers* tbl. 2.7, at 42 (Aug. 11, 2000) (actual investment is $342 billion).

[7] *See 1999 Statistics of Communications Common Carriers* tbl. 2.7, at 42 (Aug. 11, 2000) (incumbents invested $29.5 billion in capital assets in 1999).

historical costs might be considered in the Universal Service Order. *See id.* at 400-01 (¶ 707). In the Universal Service Order, the FCC ignored recovery of historical costs but suggested it might consider the question in its Access Charge Order. *See* Universal Service Order ¶ 230 n.593. In its Access Charge Order, the FCC again made no provision for recovering historical costs and instead suggested yet again that it would consider the issue in a "separate order." *In re Access Charge Reform*, 12 F.C.C.R. 15,982, ¶¶ 14, 49 (1997). Not surprisingly, that order has never materialized.[8]

The FCC's rush to implement TELRIC as the price for UNEs sold by incumbents to competitors contrasts starkly with its sputtering implementation of TELRIC in reforming federal universal service funding. In explaining its four-year delay in implementing universal service reforms, the FCC asserted that the models available for calculating TELRIC were too

[8] In contrast, other agencies have forthrightly acknowledged that they must provide recovery of costs stranded by major changes in their regulatory regimes. FERC, for example, repeatedly recognized the need to provide for stranded cost recovery in its proceeding entitled Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities. *See, e.g.*, FERC Order No. 888, 61 Fed. Reg. 21,540, 21,630 (1996) ("[W]e believe that the utility is *entitled* to recover legitimate, prudent and verifiable costs that it incurred under the prior regulatory regime to serve that customer." (emphasis added)); FERC Order No. 888-A, 62 Fed. Reg. 12,274, 12,373 (1997) (recognizing that agency "cannot change the rules of the game without providing a mechanism for recovery of the costs caused by such regulatory-mandated change"); FERC Order No. 888-B, 62 Fed. Reg. 64,688, 64,688-89 (1997) (permitting recovery of "legitimate, prudent, and verifiable wholesale stranded costs"); *see also* Council of Economic Advisors, 1996 Economic Report of the President at 187 (GPO 1996) ("A strong case therefore can be made for allowing utilities to recover stranded costs where these costs arise from after-the-fact mistakes or changes in regulatory philosophy toward competition, as long as the investments were initially authorized by regulators.").

unreliable to be used. *See, e.g.*, Universal Service Order ¶¶ 244-245; *Federal-State Joint Board on Universal Service*, Fifth Report & Order, 13 F.C.C.R. 21,323, ¶¶ 3, 60 (1998).

When the FCC did act, it left completely intact the massive implicit subsidies embedded in intrastate retail rates. *See* Universal Service Order ¶ 14. Instead, it tinkered with a tiny explicit federal fund and replaced it with a new fund calculated using TELRIC. Thus, while this Court expected that the distortions caused by implicit subsidies would "be phased out," *AT&T Corp.*, 525 U.S. at 394, the FCC has declined to implement the Act in that fashion.

The adverse effect of the FCC's radically discounted TELRIC prices, aggravated by the FCC's blanket unbundling of UNEs, was predictable. Subsidized access to the incumbent's network provided a powerful distorting incentive for entrants to rely on UNEs and at the same time devalued investments some entrants had started to make in facilities of their own. As a result, many entrants rapidly changed their plans away from deploying competing facilities.[9]

In New York alone, for example, by the end of calendar year 2000, competitors using Verizon's UNEs were serving 1.8

[9] MFS, for example, a competitive access provider that already had facilities deployed in many urban centers, quickly announced plans to "re-orient[] its network build-out focus away from building to end-users and instead . . . [to] connect[ing] to the customer via incumbent local exchange carrier unbundled loops." Merrill Lynch, MFS Communications at 2 (Nov. 7, 1996). And AT&T touted the UNE platform to investors as "another way to resell" that would give AT&T a "52 percent" discount below retail rates – more than two to three times the discounts set according to the statutory standards for wholesale services. Transcript, "AT&T Investment Community Meeting" at 5 (Mar. 3, 1997) (J.A. 469). *See also* John J. Keller, *Ringing Bell: AT&T's New President Is Wasting No Time in Shaking Things Up*, Wall St. J., Dec. 24, 1996, at A1 (explaining that AT&T canceled plans to build facilities and elected instead to purchase elements and services from incumbents).

million customers and had eclipsed facilities-based competitors. The losses imposed by TELRIC pricing for those UNEs are massive. While the average historical cost for a copper loop is $33.20 per month, the average TELRIC price for a loop is $14.52 – a discount of over 56%.[10]

In addition, implementing TELRIC pricing for UNEs while implicit subsidies remain embedded in retail rates created further foreseeable problems. *First*, entrants focused on cherry-picking high-margin urban and business customers,[11] and thereby diverted into their own coffers the revenues designed to support universal service. *Second*, because retail rates for residential customers remained below cost, competition for residential customers developed more slowly than it should have. Ironically, these below-cost retail price ceilings have led to further political pressure to reduce UNE prices even more as entrants claim that they cannot compete for residential customers unless deeper discounts enable them to match incumbents' state-imposed, below-cost retail rates. *See, e.g.*, C. Michael Armstrong, *Break Up the Baby Bells!*, Wall St. J., Mar. 28, 2001, at A22 (complaining that "Verizon's 'wholesale' price in New Jersey is twice the amount that retail customers pay").

D. Judicial Review

In their initial challenge to the Local Competition Order, incumbents argued primarily (i) that the FCC's unbundling rules providing blanket access to incumbents' networks

[10] *See Proceeding on Motion of the Comm'n To Examine N.Y. Tel. Co.'s Rates for Unbundled Network Elements*, N.Y. Pub. Serv. Comm'n Case No. 98-C-1357, Hearing Ex. 323, Part A-1, Section 5, at 1.

[11] *See, e.g., Hearing Before the Antitrust Subcomm. of the Senate Judiciary Comm.*, 1999 WL 8084924 (Feb. 25, 1999) (statement of Joel I. Klein, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice) ("These new entrants typically, and naturally, set their sights first on urban business customers as the most profitable slice of the local exchange market . . . .").

violated the terms and purposes of the Act; (ii) that the FCC lacked statutory authority to issue rules governing the Act's pricing provisions at all; and (iii) that the FCC's pricing rules – particularly TELRIC – were unlawful. The Eighth Circuit rejected incumbents' challenge to the FCC's approach to blanket unbundling. It agreed, however, that the FCC lacked jurisdiction over pricing and therefore did not address the incumbents' substantive challenges to TELRIC. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997).

In *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999), this Court agreed with incumbents that the FCC had violated the Act by failing to impose any meaningful restriction on access to network elements. The Act required the FCC "to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to do." *Id.* at 388. The Court therefore vacated the FCC's "primary unbundling rule" and remanded to the FCC. *Id.* at 375.[12]

In *AT&T Corp.*, this Court also reversed the Eighth Circuit's ruling on jurisdiction over pricing and remanded for the Eighth Circuit to address substantive challenges to TELRIC. On remand, the Eighth Circuit rejected incumbents' argument that the pricing standard in the Act required that network-element prices be based on the actual, historical costs of the incumbent's existing network. The court declared the term "cost" ambiguous and deferred entirely to the FCC's decision to base prices solely on forward-looking costs. *See* Pet. App.

[12] On remand, the FCC produced a new rule that actually *expanded* access to network elements even further. *See In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report & Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (Nov. 5, 1999). When incumbent carriers sought judicial review, the FCC succeeded in having the case held in abeyance on the ground that it intended to reconsider some aspects of the order. The agency has now been "reconsidering" the order ever since 1999, while incumbents' challenges go unheard.

10a-14a (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984)). Although the court acknowledged that incumbents had argued for a construction of the Act that would hew to constitutional standards, it applied the wrong standard to incumbents' claim as it concluded that petitioners' "takings claim is not ripe for review." *Id.* at 17a.

Incumbents also argued that, even if the Act would permit a forward-looking cost methodology, it required UNE prices to be based on the forward-looking costs actual firms would incur, not on an unattainable fantasy. The Eighth Circuit agreed and explained that the Act demanded prices based on the actual cost of providing elements to competitors, "not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute." *Id.* at 8a. In setting the pricing standards of section 252(d)(1), "Congress was dealing with reality, not fantasizing about what might be." *Id.* at 9a.

SUMMARY OF ARGUMENT

1. The plain text, structure, and purpose of section 252 make it clear that prices must include historical costs. Section 252(d)(1) requires rates for network elements that are "based on the cost . . . of providing" the network element and "may include a reasonable profit." The ordinary meaning of the word "cost" is past expenditure, and particularly where the term has been used with precisely that meaning in the field of telephone rate regulation for half a century, there is no basis for applying a different meaning here. Further, the Act's authorization of a "reasonable profit" makes sense only if "cost" refers to historical cost and "profit" refers to a return after full recovery of investment.

2. a. Constitutional considerations also require that the term "cost" be read to mean historical costs. Section 252(d)(1) requires that network-element rates be "just and reasonable," a formulation that this Court has long understood to demand

adherence to constitutional standards of just compensation. Indeed, since the Act effects a taking of property for which network-element rates are to provide the compensation, the pricing standard must be construed to adhere to constitutional norms. *See, e.g., United States v. Security Indus. Bank*, 459 U.S. 70, 78-80 (1982).

b. In *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court explained that, when a ratemaker undertakes a fundamental shift in rate methodologies, the new methodology must be evaluated to determine whether it continues to provide constitutionally adequate compensation for previous investments, as measured under the old methodology. *See id.* at 312. TELRIC violates the Just Compensation Clause because it represents a fundamental shift in methodology that makes no provision for the recovery of prior prudent investment, but rather is *designed to preclude* such recovery. TELRIC thus constitutes an extreme form of the opportunistic switch in ratemaking methodologies condemned in *Duquesne*. It impermissibly changes the rules of the game after substantial investment has been induced under the prior regulatory regime. *See Eastern Enters. v. Apfel*, 524 U.S. 498, 532-36 (1998); *Kaiser Aetna v. United States*, 444 U.S. 164, 179-80 (1979).

c. While never denying that TELRIC would strand investment, the FCC sought to salvage the methodology by claiming that it would not threaten incumbents' overall "financial integrity." But any effort to dilute the impact of TELRIC by sweeping in revenues from *all* of an incumbent's other operations violates fundamental takings principles. The government cannot take part of a person's property and claim that it need not pay for it fully on the ground that the person has remaining net worth. Rather, when the government takes a portion of a person's property it must pay fully for what it has taken. In a regulatory context, this means that a regulatory system must pay its own way. A regulator cannot make up a

deficiency in its own rates by pointing to competitive revenues, revenues under the control of a different regulator, or any other revenues it is not responsible for generating. *See Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920); *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).

The FCC's various suggestions that incumbents' constitutionally based arguments for interpreting the Act are somehow not "ripe" are equally misplaced. TELRIC is a final rule that systematically undercompensates incumbents. It is subject to review *now* for its failure to adhere to the standard of compensation spelled out in section 252(d)(1) of the Act.

d. Because, at a minimum, TELRIC raises serious constitutional questions, the agency must demonstrate a clear congressional mandate for its adoption. *See Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683 (2001); *NLRB v. Catholic Bishop*, 440 U.S. 490, 506-07 (1979). That standard is not met here. Thus, the FCC's reading of the word "cost" must be rejected. It is the Court's "settled policy to avoid an interpretation of a federal statute that engenders constitutional issues if a reasonable alternative interpretation poses no constitutional question." *Gomez v. United States*, 490 U.S. 858, 864 (1989).

3. Finally, the FCC's adoption of TELRIC is contrary to the purpose of the statute and is arbitrary and capricious. For years, the FCC and other telephone utility regulators have rejected forward-looking replacement cost models as inherently unworkable and unreliable. Rejection of historical cost in favor of the FCC's novel and unwieldy replacement-cost model frustrates the congressional goal of swift implementation of the Act. Finally, the FCC's effort to have prices reflect an imaginary and unattainable level of efficiency undermines incentives for facilities-based competition and short-circuits the very competitive process that Congress intended to set in

motion. *See AT&T Corp.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part).

ARGUMENT

I. SECTION 252(d)(1) REQUIRES USE OF HISTORICAL COSTS FOR NETWORK-ELEMENT PRICES.

The Act requires that prices for network elements "shall be . . . based on *the cost* . . . of providing the interconnection or network element." 47 U.S.C. § 252(d)(1) (emphasis added). Even assessed in a contextual vacuum, the word "cost" cannot be read to exclude past capital expenditure. The plain, dictionary meaning of the word "cost" includes the entire amount paid for any particular item or service. *See Webster's Third New International Dictionary* 515 (1993) (defining cost as "the amount or equivalent paid or given or charged or engaged to be paid or given for anything bought or taken in barter or for service rendered"); *Black's Law Dictionary* 345 (6th ed. 1990) ("Expense; price. The sum or equivalent expended, paid or charged for something."). Thus, the ordinary understanding of the word "cost" is, by its nature, "historical" – it focuses on all that has been paid to produce a good or service. The concept of "cost" — what was in fact paid for something – is distinct from the concept of "value," which is the price that would be paid on the open market.

More importantly, in the specific context in which the word is used here – telephone utility ratemaking – the term "cost" has been used for more than fifty years to refer to this same concept of past expenditure, or "historical cost." *See* James C. Bonbright *et al.*, *Principles of Public Utility Rates* 211 (2nd ed. 1988) ("[O]riginal, legitimate cost of plant and equipment, with reasonable allowances for interest during construction and for working capital, is the governing basis of calculation."); *see also MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1118 n.52 (7th Cir. 1983) ("cost" is interpreted "in a utility ratemaking setting to refer to the revenues required

to meet all the accounting, historical or embedded costs of the entire utility enterprise" (emphasis omitted)); Hon. Stephen Breyer, *Regulation and Its Reform* 38 (1982) ("[R]egulators almost uniformly assume that a firm's rate base (which determines the allowable profit) equals the book value of its *historical* investment."). Indeed, two years before Congress enacted section 252, the FCC itself reaffirmed, in the context of cable rate regulation, that "[o]riginal cost is the normal, now traditional method used for public utility valuation." *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Report & Order and Further Notice of Proposed Rulemaking, 9 F.C.C.R. 4527, 4555, ¶ 55 (1994).

Where a statute addresses a specialized field and uses a term that has acquired a fixed meaning in that context, the statute must be construed to apply that settled meaning. *See McDermott Int'l, Inc. v. Wilander*, 498 U.S. 337, 342-43 (1991) (construing the undefined statutory term "seaman" to have its established meaning under maritime regulation); *Corning Glass Works v. Brennan*, 417 U.S. 188, 201-02 (1974) (construing the undefined statutory term "working conditions" to have its established meaning under labor regulation). Although the FCC points to the theoretical possibility that the word "cost" can mean different things in *different* contexts, the fact remains that, in the context in which the word is used here, "cost" has had a consistent meaning for decades – *i.e.*, "historical" cost. Given this longstanding usage, it is implausible to conclude that rates "based on the cost" would exclude past capital investment.

Beyond the word "cost" itself, the text and structure of several interrelated provisions of sections 251 and 252 confirm that section 252(d)(1) uses the word "cost" in its usual sense. First, section 252(d)(1)(B) states that the prices for network elements "may include a reasonable profit." A profit cannot be realized absent full recovery of costs, including capital costs.

California Dental Ass'n v. FTC, 526 U.S. 756, 768 (1999) ("[A]ccording to a generally accepted definition 'profit' means gain from business or investment over and above expenditures, or gain made on business or investment where both receipts or payments are taken into account . . . ." (internal quotation marks omitted)). The FCC itself acknowledged that, "in plain English, profit is defined as 'the excess of returns over expenditure in a transaction or a series of transactions.'" J.A. 393 (¶ 699) (citing *Webster's New Collegiate Dictionary* 931 (10th ed. 1994)). Yet the FCC treated return on investment as simply another forward-looking "cost." This left no room for consideration of what constituted a reasonable profit because, in the agency's view, profit was "embodied" in its own definition of cost. *See* J.A. 393-95 (¶ 700). The FCC's reading thus renders irrelevant the entire subsection of the Act addressing "profit," thereby violating a cardinal canon of statutory construction. *See, e.g., Bennett v. Spear*, 520 U.S. 154, 173 (1997); *United States v. Menasche*, 348 U.S. 528, 538 (1955).

The Act's bifurcation of the pricing determination into "cost" and "profit" neatly tracks the two-step process traditionally associated with cost-of-service ratemaking. Historical expenditure constitutes the ratebase, to which a rate of return calibrated to the nature and risk of the industry is applied. The use of the word "reasonable" to modify "profit" supports this view. It has meaning in this context only as a reference to the exercise of discretion by a regulator in setting a rate of return. If "cost" in section 252(d)(1)(A) is read as exclusively "economic cost," the phrase "reasonable profit" in section 252(d)(1)(B) is a non sequitur.

Second, several provisions of the Act make clear that it does not authorize or contemplate a wholesale reexamination of the incumbent carriers' actual costs. The FCC was required to "complete all actions necessary" to implement the local competition provisions, including pricing standards, within six

months of the Act's enactment. *See* 47 U.S.C. § 251(d)(1). Section 252(d)(1) itself expressly forbids the conduct of a traditional ratemaking inquiry: "cost," it directs, shall be "determined without reference to a rate-of-return or other rate-based proceeding." The FCC itself explained that this directive "does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed." J.A. 397-98 (¶ 704). And as the FCC noted, Congress was "eager to set in motion expeditiously the development of local competition" and wished to avoid "the costs and administrative burdens associated with a traditional rate case." *Id.* The strong inference from the congressional desire for swift action and the limitations Congress placed on the procedures to be employed is that "cost" refers to something already established and readily available, *i.e.*, historical cost as documented on incumbents' books. The Act's prohibition of familiar ratemaking procedures in the name of rapid implementation plainly forbids, *a fortiori*, the use of a novel, complex, and difficult-to-administer hypothetical cost model.[13]

The parallel provisions in the Act for determining wholesale prices for *services* to be resold (as opposed to "*elements*") further support the conclusion that "cost" in section 252 includes historical cost. In the resale context, the Act provides for wholesale prices based on retail rates, which Congress noted would continue to permit incumbents to recover

[13] Similarly, because it precludes the traditional procedures associated with the adjustment or reduction of a utility's rate base, the Act necessarily suggests that Congress intended that rates be based on existing cost figures. Any other approach would raise due process concerns. Rudimentary principles of due process would require notice and a right to be heard before incumbents could be denied recovery of prudent capital investments whose recovery had previously been approved by state regulators. *See Ohio Bell Tel. Co. v. Public Utils. Comm'n.*, 301 U.S. 292, 300 (1937); *West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662, 675-77 (1935).

historical costs. *See* H.R. Rep. No. 104-204, at 72 (1995). Having preserved the incumbent's opportunity to recover historical costs on the resale of *services*, Congress can hardly be thought to have contemplated the exclusion of all historical costs for the pricing of network *elements*. If Congress was not "fantasizing" about hypothetical costs in the context of pricing services, it is implausible to maintain that it nonetheless authorized a purely hypothetical standard for pricing network elements. *See Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995) (statutes are to be interpreted as part of "a symmetrical and coherent regulatory scheme").

Finally, as discussed below, under *Chevron* step one constitutional considerations constrain the permissible reading of the word "cost" for two reasons: (1) the Act's requirement of "just and reasonable" rates expressly incorporates a constitutional standard; and (2) the doctrine of constitutional avoidance precludes an interpretation that raises serious constitutional questions. *See, e.g.*, *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 n.9 (1984) (court employs all "traditional tools of statutory construction" on first step of *Chevron*); *Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683-84 (2001) (same).

II. UNDER CONSTITUTIONAL PRINCIPLES, SECTION 252 CANNOT BE CONSTRUED TO AUTHORIZE TELRIC.

Because of what it says and because of what it does, section 252 must be construed to mandate constitutionally sufficient compensation. The Act's command that rates be "just and reasonable" explicitly incorporates the constitutional standard of just compensation. Moreover, because the Act effects a taking of property for which network-element rates are to provide the compensation, the rates must satisfy constitutional norms.

The FCC has fundamentally shifted rate methodologies in midstream so as to preclude incumbents from recovering their embedded costs – that is, past prudent investment made in reliance on the prior regulatory regime. The FCC's action is precisely the kind of opportunistic switch this Court condemned in *Duquesne*. Because TELRIC violates the Constitution, it violates the Act.

A. Section 252 Mandates a Pricing Methodology Designed To Provide Constitutional Compensation.

In requiring that rates be "just and reasonable," section 252(d)(1) incorporates the Fifth Amendment's guarantee of just compensation and thus expressly commands that any rate methodology be designed to produce the full measure of compensation due under the Constitution. The phrase "just and reasonable" is a term of art that has long been construed to require compensation that meets constitutional standards. *See, e.g., In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

Section 252 is a classic utility rate regulation scheme. It forces a dedication of property, it directs compensation through just and reasonable rates, and it designates a class of users required to pay the compensation through those rates. Thus, the overarching purpose of section 252 is *compensatory*. Its core command – as with any utility ratemaking regime – is not only that incumbents should receive full compensation, but also that they should receive full compensation *through the rates*. The very objective of a utility ratemaking regime is to avoid future government liability for an uncompensated taking by requiring the regulator to design rates that will fully compensate the utility. Such a regime ensures that the utility is fully compensated, that the liability for compensation is borne by a designated class of private users (not by the public treasury), and that investors' expectations are settled by a predictable mechanism that informs investors in advance how they will be paid.

The Fifth Amendment is implicated in this case because, under the 1996 Act and the FCC's implementing regulations, incumbents are being compelled to turn over parts of their networks for their competitors' exclusive use. *See* J.A. 285-86 (¶ 268) (an entrant purchasing "access to an unbundled network facility is entitled to exclusive use of that facility for a period of time"). The Act thus accomplishes a taking that demands constitutionally adequate compensation. Where a utility is compelled to dedicate its property to public use, the government must provide the utility the full compensation due under the Constitution. *See, e.g., Duquesne*, 488 U.S. at 307-08.

It is because of this imperative for just compensation that utility statutes, like the one here, are often explicit in demanding "just and reasonable" rates. But even in the absence of such specific direction, this statute would have to be construed to provide compensation that meets the constitutional minimum. Where Congress conscripts private property for public use and establishes a mechanism for compensation, the strong presumption must be that Congress intends the mechanism itself to provide the full measure of compensation due under the Constitution. *See, e.g., Phelps v. United States*, 274 U.S. 341, 344 (1927). And especially in the utility context where the statute not only effects a taking but also prescribes a class of persons to pay, the rates must provide constitutional compensation. An agency cannot be permitted to create unintended liability for the Treasury by construing the statute in a manner that would result in an uncompensated taking of property. *See Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

For these reasons, the Constitution constrains any construction of the word "cost" in section 252(d)(1). That term *must* be construed to preserve the opportunity for incumbents to recover all costs they are entitled to recover under the Constitution. An agency interpretation of that term that fails to provide for such recovery violates the statute and the constitutional standard that it incorporates. Moreover, the agency's interpretation of what costs the Constitution requires

to be recovered is not entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). This is so not only because an agency's interpretation of constitutional requirements generally is not entitled to deference, *see infra* pp. 42-44, but also because the judiciary, not the political branches, has the exclusive province to determine what just compensation requires. *See, e.g.*, *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 327 (1893) ("It does not rest with the public, taking the property, through congress or the legislature, its representative, to say what compensation shall be paid, or even what shall be the rule of compensation.").

B. TELRIC Violates Section 252(d)(1) Because It Shifts Methodologies Without Providing for Recovery of Past Prudent Investment.

In its Local Competition Order, the FCC made a profound change in the measure of costs incumbents are permitted to recover. It abandoned the longstanding regime under which incumbents were given the opportunity to recover their actual investment and moved to an extreme version of replacement costs. This fundamental shift in methodologies necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime. The principles established by this Court in *Duquesne* provide the template for evaluating such shifts.

At the inception of a regulatory regime, when investors first choose to dedicate their property to public use, a regulator has some flexibility in choosing a methodology for determining compensation. Any of several methods, including an historical cost method or a reproduction-cost method, could satisfy constitutional requirements. *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). Once the government has selected a methodology and induced substantial investment under that regime, however, the government's ability to *switch* methodologies is necessarily constrained.

After the government has induced private investment that has produced valuable property under one set of regulatory rules, there will often be a strong temptation to use government power to appropriate some or all of that value to the benefit of the public at reduced cost. Changing rate methods in midstream can accomplish precisely such an appropriation of value by effectively foreclosing recovery of a constitutional return on the very investments that were made in reliance on the original method. No less than in other instances of expropriation of private property, the Fifth Amendment precludes the government from inducing substantial investment in reliance upon one set of rules and then reaping the rewards of that investment by unilaterally altering the rules of the game. The Constitution thus does not preclude all changes in methodology. What it *does* preclude is a switch in methodologies unaccompanied by some mechanism to compensate for investment stranded by the shift in methodologies itself. This is simply a specific application of the bedrock principle that "a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change." *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 416 (1922) (Holmes, J.).

In *Duquesne*, the Court applied this principle in evaluating a shift in ratemaking methodologies. *Duquesne* involved a "sligh[t] modifi[cation]" of the rate method within the context of an historical cost system. 488 U.S. at 310. Rather than allowing some recovery of investments that, although prudent when made, had not proved "used and useful," the new method eliminated any recovery for such investments. *Id.* at 304-05, 310 n.7. The Court evaluated whether this slight change raised constitutional difficulties by determining whether the shift adversely affected investors' opportunity to recover all their previous prudent investment and an appropriate rate of return under the old methodology. The Court determined that the new method was still projected to produce recovery that was "within the constitutional range of reasonableness" *as measured under the old methodology*. *Id.* at 312. Under *Duquesne*, in other

words, the new system must still provide for recovery of the investments made under the prior system *and* a return on that investment that would have been constitutionally sufficient under the old system. Indeed, in concurrence, Justice Scalia, joined by Justices White and O'Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." *Id.* at 317.

The FCC's newly minted TELRIC methodology plainly fails the *Duquesne* test. *Duquesne* involved a slight modification within the context of an historical cost rate method. Here, in contrast, TELRIC jettisons historical costs altogether in favor of an extreme version of replacement costs. The FCC fully understood that TELRIC rates would be below historical costs and would not allow recovery of those costs. That was the intent of TELRIC, *see supra* p. 9, and, given the assumptions built into the methodology, its inexorable effect. TELRIC thus, *by design*, falls short of satisfying the constitutional test applied in *Duquesne*. The FCC never disputed that TELRIC would strand investment on UNEs. Nor could it do so. The FCC itself set "proxy prices" to approximate TELRIC and produced forward-looking costs that are roughly 60% below historical costs. *See supra* p. 10. With a stroke of the pen, the FCC thus redefined as "unrecoverable" half the costs that incumbents have incurred in establishing and maintaining the networks that now must be sold off piecemeal to new entrants.

As if forewarning against the FCC's conduct here, the *Duquesne* Court contrasted the slight shift in that case with changes that more fundamentally alter risks. *See* 488 U.S. at 312 n.7, 315. The Court admonished against shifts that would allow the government opportunistically to reap the benefits of investments without paying for them: "[A] State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise *serious constitutional questions*." *Id.* at 315 (emphasis added).

The FCC's abrupt shift to TELRIC is precisely the sort of fundamental and opportunistic switch condemned in *Duquesne*. For decades, regulators have reaped the benefits of the historical cost method, which worked to the government's advantage as long as asset values were stable or rising. By promising investors a fair opportunity to recover all capital prudently invested and insulating them from the risk of asset value fluctuation, regulators could insist on lower rates of return and extended depreciation schedules. Because they did not have to compensate investors for the risk that their investments would suffer fluctuations in market value, regulators could keep consumers' rates low and stable. For their part, investors were never allowed to profit when the value of the network was increasing. Returns were based on capital investment. Most importantly, for all the investment sunk under the prior regime, investors have never been compensated for the risk that recovery would be based on the vagaries of fluctuations in asset value.

The FCC has used the Act as an opportunity to conjure up a hypothetical world where replacement costs are substantially below book value. And it has used its newfound regulatory authority to impose that extreme version of a replacement-cost methodology on incumbents – a shift it seeks to make without ever having paid investors for the risk of such a shift and without providing for the investment that will be stranded as a result.

The FCC's bait-and-switch is particularly egregious here, moreover, because the regulators' own decisions have magnified the amount that will be stranded by the shift. One of the ways regulators promoted universal service under the prior system, for example, was artificially prolonging depreciation lives to push off recovery of costs into the future. *See supra* p. 4. That meant that incumbents carried accounts reflecting undepreciated investments in assets, even though those accounts no longer corresponded to the economic value of the assets. Switching to TELRIC abruptly cuts off recovery of those amounts, even though recovery had been promised as a critical component of the past system.

The harsh retroactivity of the FCC's about-face is patent. The switch effectively reaches back and recharacterizes the legal effect of an incumbent's actions by recategorizing investments that were prudent (and therefore could be recovered) as now unrecoverable – long after the investments were made. TELRIC thus has the effect of rewriting the terms of thousands of regulatory transactions closed long ago. *See Eastern Enters. v. Apfel*, 524 U.S. 498, 532-36 (1998); *see also id.* at 548 (Kennedy, J., concurring) ("If retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership."). It accomplishes that result by suddenly exposing the utility to a regulatory risk – repricing based on the unattainable efficiencies of an imaginary carrier – that was never accounted for in the original method for determining compensation. The effect is to wipe out a significant portion of the recovery on past investments that had always been counted on as a necessary component for supplying a constitutional return under the old regime.

Investors never would have agreed to invest the huge sums necessary to construct a telephone network if, rather than offering a stable opportunity to recover all prudent investments, the government had instead reserved the right to eliminate any opportunity to recover investments upon a whim. In this instance no less than in others, the Court must look with extreme skepticism on government action that would eliminate the basis on which private parties have relied in making substantial investments. *See, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 179-80 (1979) (government consent to plan to dredge pond created "expectancies" amounting to a property interest that the government could not later frustrate by declaring pond a navigable waterway open to public without paying just compensation); *cf. United States v. Winstar Corp.*, 518 U.S. 839, 863-64 (1996) (plurality opinion); *id.* at 913 (Breyer, J., concurring) (government adherence to contractual obligations is necessary to induce private parties to "undertake the risk of government contracting").

Duquesne simply recognizes that, where the government has invited reliance on its regulatory system to induce investment, it cannot fundamentally alter the rules with impunity. TELRIC violates *Duquesne* because it changes rate methodologies without providing any mechanism to preserve incumbents' opportunity to recover prior investments made in reliance on the historical cost regime.

C. The FCC's Efforts To Deflect Scrutiny from the Constitutional Defects in TELRIC Are Meritless.

Throughout the rulemaking proceeding the FCC peremptorily dismissed the "serious constitutional questions" identified in *Duquesne*. Incumbents repeatedly insisted that they were entitled to an opportunity to recover their embedded costs and proposed numerous alternative mechanisms that would have at least preserved the opportunity to recover embedded costs that were not recoverable through TELRIC rates. *See* J.A. 398-99, 399-400 (¶¶ 705, 706). The FCC responded that, "[e]ven if the incumbent LECs' contention is correct," *id.* at 399-400 (¶ 706), setting rates to allow recovery of embedded costs stranded by TELRIC would "interfere" with its policy goals of managing competition to optimize "efficient" entry. *See id.* But the FCC's policy predilections cannot excuse its failure to comply with the dictates of the statute and the Constitution.

The FCC conclusorily asserted that the amount of investment stranded by TELRIC would not "necessarily" be "significant." *Id.* at 400-01 (¶ 707). But the FCC's statutory and constitutional duty was to ensure that incumbents were fully compensated for the newly established UNE wholesale business. Prices for network elements must reflect the "cost" of the elements, not some lesser portion of the cost based on the agency's unexplained pronouncement that the difference is not "significant." The FCC cannot deny that TELRIC prices are half the historical costs of UNEs and therefore require incumbents to operate the entire wholesale enterprise at a substantial loss. In addition, as explained more fully below, the significance of the losses caused by TELRIC cannot be watered

down by looking at the company's overall financial position. *See infra* pp. 32-37.

Ultimately, the FCC has advanced two legal arguments to justify its failure to make any provision for the recovery of past investment. The first argument – advanced in the Order itself – is that, although the UNE rates will not in themselves allow recovery of historical investment, they are not confiscatory because incumbents have not shown that their overall "financial integrity" would be impaired. J.A. 420-22 (¶¶ 736-738). The second argument – advanced in litigation and embraced by the court below – is that incumbents' arguments are somehow not "ripe." Both lines of argument are fallacious.

1. Under the "total effect" test, TELRIC's deficiencies cannot be cured by looking to revenues earned from *all* of an incumbent's operations.

The FCC seeks to deflect the charge that TELRIC rates are confiscatory by claiming that the rates need not provide constitutionally sufficient recovery in themselves. Instead, in its Order, the FCC distorted the *Duquesne* "total effect" test by claiming that it could look to *all* of an incumbent's overall revenues to make up for any deficiency in TELRIC rates. It thus concluded that TELRIC rates would not be confiscatory because unspecified "revenues from other services" might make up any shortfall, J.A. 421 (¶ 737), and because incumbents had not proven that their overall "financial integrity" would be impaired, *id.* at 421-22 (¶ 738). The FCC's conclusion that it can compel an incumbent to sell UNEs at noncompensatory rates, so long as the firm as a whole remains profitable, violates the most basic tenets of the Just Compensation Clause as well as section 252's command that UNE rates be "just and reasonable."

It is axiomatic that, when the government takes some portion of a person's property, it must pay in full for the part it has taken. The government cannot take property from a person and evade compensation on the ground that the person still has remaining net worth or, in the case of a corporation, a

profitable bottom line. Thus, the government could not compel General Motors to sell Chevrolets below cost simply because, due to earnings on Cadillacs and Buicks, the company as a whole remained profitable.

This principle applies with full force where, as here, an agency has ratemaking power over *part* of a firm's overall business. This Court long ago recognized that, where a regulator controls revenues in only a segment of a firm's overall business, it must allow the particular enterprise over which it has control to make a sufficient return to stand on its own. The regulator may not force the enterprise it is regulating to operate at a loss and claim that the deficiency can be covered by other parts of the firm's business whose revenues the regulator is not responsible for generating. Thus, in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920), the seminal case applying this principle, this Court held that regulators could not justify below-cost railway rates by claiming that the railroad was still profitable due to healthy returns in its competitive lumber business.

The principle underlying *Brooks-Scanlon* is that a regulator may not set below-cost rates in one line of business and claim that the deficiency is offset by revenues from a different line of business unless it can legitimately claim responsibility for generating those off-setting revenues – as, for example, where the regulator has used its power to enable an off-setting supracompetitive return. Thus, as the *Brooks-Scanlon* Court recognized, a regulator cannot take credit for revenues earned in a competitive market because it is not responsible for those revenues and they represent the return due the firm for risking capital in the competitive enterprise. As Justice Holmes explained, earnings from competitive operations are the firm's private property, and a firm "no more can be compelled to spend that [money] than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it." *Id.*

The same underlying principle is reflected in the rule that a regulator may not justify deficient rates by pointing to revenues

from operations under a different sovereign's jurisdiction. *See, e.g.*, *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930); *Chicago, M. & St. P. Ry. v. Public Utils. Comm'n*, 274 U.S. 344, 350-51 (1927). The first regulator cannot claim that its action enabled the firm to earn those revenues and thus cannot claim credit for them as a "payment" to compensate for any shortfalls in rates it has imposed. Those revenues are already spoken for: the *other* sovereign has determined that they are necessary to compensate the utility for the business conducted under *its* jurisdiction.

The "total effect" test from *Duquesne* is fully consistent with these principles. Contrary to the FCC's assertion, that test does not give a regulator license to rely on revenues outside its control to cure a deficiency in the rates it has set for a regulated service. Rather, the "total effect" test focuses solely on *those revenues the regulator has control over and is responsible for generating*. It simply provides that, where a regulator has control over multiple services of a firm, it may set the rate for one service below cost so long as it compensates for the shortfall by using its regulatory power to enable an offsetting extra return on another product. Thus, where a regulator uses its regulatory power to restrict competitive entry, it can legitimately claim credit for the off-setting revenue because it has enabled the supracompetitive return. In short, the test simply recognizes that a regulator may create cross-subsidies *within* the range of services under its regulatory control. It is in this context that this Court has said that subsidiary puts-and-takes in a rate order are not of constitutional dimension, as long as the regulator has set rates in the aggregate to provide a sufficient return on the regulated part of the business under its control. *See Duquesne*, 488 U.S. at 310, 314.

In *Hope* and *Duquesne*, the company at issue was a regulated monopoly in *all* its operations. In those cases, therefore, it was proper to consider the company's overall revenue from all operations in determining the sufficiency of a rate order. But those cases clearly do not mean that, where a regulator's control is limited to part of a business, that regulator can justify a non-compensatory rate on a regulated service by claiming that

revenues from sources outside its control make up the difference. Thus, the core principle under the total effect test is that the regulator can claim credit only for revenues that are under its control and that it is in fact responsible for generating through restrictions on competition or other uses of its regulatory power.[14]

Thus, the FCC's duty – both under the foregoing principles and the express directive of section 252 – was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own. The Act established a new UNE wholesale business, and section 252's command that rates be "just and reasonable" and "based on the cost . . . of providing" the UNE was directed specifically at ensuring that UNE rates fully covered the costs of that business. Congress thus intended that the costs of UNEs be reflected in UNE prices – not in the prices for other services. For ratemaking purposes, therefore, the FCC was required to treat the UNE business as a discrete enterprise and set rates sufficient to allow that enterprise to pay for itself. Apart from this statutory obligation, the principles underlying *Brooks-Scanlon* prohibited the FCC from justifying deficient UNE rates by pointing to other revenues that it could claim no credit for generating. In any event, looking to revenues from any other source to make up for deficient UNE rates would mean creating a new cross-subsidy in rates, an approach that runs flatly counter to the express congressional directives elsewhere in the Act to ensure that implicit subsidies are eliminated. *See, e.g.*, 47 U.S.C. § 254(d), (e); *see also*

---

[14] The Supreme Court of California applied this principle to strike down a statutory test for determining the adequacy of insurance rates where the test "refer[red] to the financial position of the company as a whole, not merely to the regulated lines of insurance." *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989). The court explained: "If an insurer had substantial net worth, or significant income from sources unregulated by [this statute], it might be able to sustain substantial and continuing losses on regulated insurance without danger of insolvency. In such a case the continued solvency of the insurer could not suffice to demonstrate that the regulated rate constitutes a fair return." *Id.*

AT&T Corp., 525 U.S. at 393-94 (section 254 "requires that [implicit] universal-service subsidies be phased out").

The FCC's reasoning in paragraphs 736-738 of the Order flatly contravenes these basic precepts. Incumbents are engaged in numerous businesses over which the FCC has no ratemaking authority. These include businesses that have long been competitive, such as wireless service and yellow pages, as well as the traditional retail local telephone business, now open to competition and still under state regulatory jurisdiction. It is plainly impermissible for the FCC to claim that revenues from any of these businesses can be counted to offset deficient UNE rates. Indeed, the FCC expressly acknowledged that, in evaluating the adequacy of TELRIC rates, it could consider solely revenues under its jurisdiction. *See* J.A. 421 (¶ 737 n.1756). While vaguely suggesting that "revenues for other services under [its] jurisdiction" might be counted, *id.* at 421 (¶ 737), the FCC never identified which revenues those were, nor could it do so.[15]

In the very next paragraph, the FCC did a complete about-face. Having just acknowledged that it could look only to revenues under its jurisdiction, the FCC concluded that TELRIC rates are sufficient because incumbents have not shown that their overall "financial integrity" will be impaired. By using that standard, the FCC failed to limit its inquiry to revenues for which it was responsible and instead sought to conscript *all* of an incumbent's revenues to cure the obvious inadequacy of TELRIC rates. This is plainly impermissible.

[15] The primary sources of revenue regulated by the FCC are interstate access charges and interstate long distance rates. But access charges are set to compensate incumbents for the cost of transporting interstate traffic over their local networks. While the FCC has at times suggested that it might consider adjustments to access charges to address stranded historical costs, *see* Universal Service Order ¶ 230 n.593, it has never raised those charges to compensate for below-cost UNE rates. Instead, it simply avoided the issue in its Access Charge Reform Order. *See supra* p. 12. As for revenues from incumbent LECs' nascent entry into interstate long distance markets, those markets are highly competitive and thus also provide no source of revenues for the FCC to count.

The FCC thus failed to conduct the inquiry demanded by *Duquesne* – whether TELRIC rates for UNEs will preserve incumbents' opportunity to recover their past prudent investment. It sidestepped the issue by applying an improper standard – whether TELRIC rates are so disastrously deficient that they will drag an incumbent's entire enterprise into financial jeopardy.

2. TELRIC must be evaluated now as a final agency action that is contrary to the Act.

The FCC's second effort to avoid any scrutiny of TELRIC conflates several distinct concepts. The FCC contended below, and the Eighth Circuit held, that petitioners' constitutionally based arguments are somehow not "ripe"; that TELRIC cannot be evaluated against constitutional standards now because it is impossible to challenge a rate methodology; and that petitioners' claims concerning inherent constitutional defects in TELRIC should instead be addressed in dozens (or hundreds) of federal district court actions on review of individual arbitrations under section 252(e)(6) of the Act. None of these contentions can withstand scrutiny.

First, assertions that incumbents' "takings claim" is not "ripe" are wholly out of place. In this case, petitioners have not brought a takings claim seeking compensation. Instead, this action is a petition for review, pursuant to the Administrative Procedure Act, seeking an evaluation of whether the FCC has acted unlawfully by promulgating a rule that violates the 1996 Act. The relief petitioners seek is correction of the FCC's pricing methodology so that it carries forth Congress' intent to provide for recovery of embedded costs through the rates paid by third-party users. This is thus a challenge to final agency action, and the petition for review and the constitutional arguments that underpin it are indisputably ripe for consideration. It is quintessentially the role of this Court to review claims that the agency is not properly implementing its enabling statute.

Second, to the extent the FCC's blanket assertions that courts "cannot review a methodology" are meant to suggest that only

specific sets of rates can be reviewed and that an underlying methodology is immune from review, that is plainly not the law. An agency's selection of a rate methodology is subject to judicial review – and has always been reviewed – in the same way as other final agency actions: for compliance with the governing statute and requirements of reasoned decisionmaking. Ratemaking is by its nature a teleological process by which the ratemaker must define the target at the outset – what costs are required to be recovered under the statute – and then must develop a methodology reasonably aimed at achieving that recovery. In other words, ratemaking requires a regulator to define the acceptable outcome in advance and to choose a method designed to achieve that end. And the agency must determine whether the *projected* outcome of its methodology meets the statutorily prescribed objective. *See Permian Basin*, 390 U.S. at 792; J.A. 420-21 (¶ 736) (acknowledging that, in adopting TELRIC, FCC must "consider whether the end result of incumbent LEC rates is just and reasonable"). This requirement is but a specific application of the broader principle that, when it takes property, the government must make a "reasonable, certain, and adequate provision for obtaining compensation *at the time of the taking*." *Presault v. ICC*, 494 U.S. 1, 11 (1990) (emphasis added) (internal quotation marks omitted).

This Court has repeatedly entertained challenges to rate methodologies at the time of their promulgation to determine whether they were rationally designed and projected to provide a constitutionally adequate return. In *Duquesne*, for example, the Court examined the effect that a new rate method "will" have. 488 U.S. at 312; *accord Hope Natural Gas*, 320 U.S. at 603-05; *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 596-98 (1942); *West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662, 675-77 (1935); *see also Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc) (under "total effect" test, a court must determine whether a "rate order may reasonably be *expected* to

maintain financial integrity and attract necessary capital") (emphasis added) (internal quotation marks omitted).[16]

Thus, where, as here, a methodology is not designed to achieve an acceptable outcome, a firm is not relegated solely to piecemeal attacks on specific rates resulting from the defective methodology. Rather, the firm may challenge the defective methodology itself. Were it otherwise, no methodology the agency put in place – no matter how deliberately non-compensatory or capricious – could be challenged. The agency could set compensation by spinning a roulette wheel each year, and the utility would be limited to annual challenges to the results produced by the roulette wheel.[17]

Here, as outlined above, the Act must be read, in light of *Duquesne*, to provide for recovery of embedded costs. TELRIC is expressly designed to *preclude* that recovery. Nothing more is required for the Court to be able to determine now that TELRIC does not comply with the Act.

At times, the FCC's vague claims about "ripeness" seem intended to suggest that TELRIC cannot be evaluated now because it is somehow uncertain whether TELRIC will produce figures higher or lower than historical costs. That is nonsense.

---

[16] The FCC would turn these precedents on their head. Pointing to the fact that the courts in some of these cases found the methodological errors inconsequential, the FCC leaps to the grand claim that *no* methodology may ever be reviewed. That misses the point: first, the courts *were* reviewing the methodology in those cases, and second, where they found subsidiary mistakes inconsequential it was *precisely because* they could determine that the methodologies, despite any possible errors, were still aimed at and were projected to achieve an acceptable outcome. The Court has never suggested that a methodology is immune from review when it is *designed* to produce inadequate results.

[17] Indeed, the FCC's wait-and-see mantra begs the question: When is the "end result" arrived at that makes it possible to evaluate the impact of a methodology? Apparently, in the FCC's view, it is arrived at when the continuing losses mount to the magnitude that they impair the overall financial integrity of the company. In other words, the FCC's vague ripeness claims are merely a repackaging of its erroneous contention that the government can take incumbents' property without compensation for as long as incumbents remain financially viable overall.

The FCC adopted TELRIC with the *express purpose* of producing prices lower than historical costs, *see supra* p. 9, and applications of TELRIC both in the FCC's own proxy prices and in state arbitrations have produced massive discounts below historical costs, *see supra* pp. 10-11. In any event, feigned agnosticism concerning the outcome TELRIC will produce relative to historical costs, far from providing a reason to hold judicial review at bay, only highlights another FCC error. As explained above, an agency charged with ensuring "just and reasonable" rates has a duty to establish a methodology *designed* to produce constitutional compensation. The FCC cannot avoid its duties by suggesting that, though not designed to do so, TELRIC *might* serendipitously end up covering incumbents' historical costs in the end. That is the antithesis of the project Congress demanded. Section 252(d)(1) requires reasoned decisionmaking, not agnosticism. It requires shooting at a defined target, not shooting in the dark.

Third, the FCC has also suggested that judicial review must wait because, even though the FCC has cut the rate base in half by precluding consideration of historical costs, States in individual arbitrations might somehow set rates of return at sufficiently supranormal levels that prices will ultimately cover historical costs anyway. Thus, the FCC has argued that incumbents must wait to challenge specific rate determinations as they arise from individual arbitrations. But the rates that TELRIC will produce are necessarily unlawful because the FCC's Order expressly *foreclosed* the States from addressing and rectifying the core defects in TELRIC. The FCC prohibited setting rates of return with a view to allowing historical cost recovery. *See* 47 C.F.R. § 51.505(d)(1). Indeed, the agency repeatedly stated that setting UNE rates to cover historical costs would interfere with the FCC's policy objectives. *See* J.A. 398-400 (¶¶ 705-706). The FCC's order, moreover, requires the States to start with the existing rate of return, and places the burden on incumbents to demonstrate with specificity that the business risks – defined exclusively in terms of facilities-based entry by competitors – justify any change in the rate of return. *See* J.A. 395-96 (¶ 702). In short,

the FCC sharply cabined the States' discretion to ensure that they would not adjust the rate of return to produce rates sufficient to cover historical costs, or otherwise to ensure that the overall effect of the rates is compensatory. Correction of the FCC's methodological errors by the States would thus be impossible.

Because state commissions cannot correct the central defect in TELRIC, district court actions under section 252(e)(6) to review individual arbitrations are simply not a mechanism for addressing incumbents' claims. Indeed, the notion that incumbents' claims can be shunted off to section 252(e)(6) cases suffers from a further defect. The district court's primary role in a section 252(e)(6) case is reviewing a state arbitration for compliance with the Act as interpreted by the FCC, not entertaining challenges to the FCC's directives. In fact, the government has argued that, if FCC rules are not struck down on direct review, they "are no longer subject to further challenge in district court proceedings under section 252(e)(6)," Br. for FCC & U.S. at 40 n.14, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) (No. 97-831), and at least one court of appeals has agreed, *see GTE South Inc. v. Morrison*, 199 F.3d 733, 742-43 (4th Cir. 1999).

In addition, it is ironic that the FCC would now hold out the possibility of state-by-state jiggering of the rate of return as the cure-all for TELRIC. The suggestion that individual States, while barred from explicitly considering historical costs, might nonetheless jury-rig some adjustments to come up with numbers that cover those costs in the end plainly cannot salvage TELRIC as a product of reasoned decisionmaking by the FCC. The FCC, moreover, previously insisted before this Court that the Act required nationally uniform implementation and that the sort of state-to-state variation it is now touting would lead only to "anticompetitive uncertainties that would impair effective implementation" of the Act. Br. for FCC & U.S., *supra*, at 41. Indeed, the FCC criticized the "protracted and piecemeal litigation" of section 252(e)(6) actions – which it now offers as the only avenue for incumbents to raise their claims – as a wholly inadequate mechanism for addressing

"fundamental disputes about the core provisions of the 1996 Act." *Id.* at 16.

D. Section 252(d)(1) Should Be Construed To Avoid the Serious Constitutional Questions TELRIC Raises.

The Court need not decide that TELRIC violates the Constitution to grant the petitions for review. Statutes must be interpreted not only to avoid constitutional *violations*, but also to avoid the need to reach *serious constitutional questions*. It is the Court's "settled policy to avoid an interpretation of a federal statute that engenders constitutional issues if a reasonable alternative interpretation poses no constitutional question." *Gomez v. United States*, 490 U.S. 858, 864 (1989); *see also Legal Servs. Corp. v. Velazquez*, 121 S. Ct. 1043, 1050 (2001); *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring).

This principle of judicial restraint decides this case. Petitioners maintain that the Act requires using historical costs for network-element prices. *See supra* pp. 19-31. It is indisputable that an interpretation of the word "cost" in section 252(d)(1) that includes historical costs is at least one *permissible* reading of the statute. It is also undisputed that network-element prices that recover historical costs and a reasonable return are beyond constitutional reproach.

On the other side of the equation, in TELRIC the government has "switched" ratemaking methodologies in a manner that will necessarily preclude recovery of significant amounts of prudent capital investment. In *Duquesne*, this Court described such a radical shift in valuation methods in the very language used by the *Ashwander* line of cases when it stated that such a shift "would raise serious constitutional questions." *Duquesne*, 488 U.S. at 315. And as explained above, TELRIC surely presents, at a minimum, serious questions of confiscation of incumbents' property.

Thus, assuming *arguendo* that there are two permissible readings of the words "the cost . . . of providing the . . . network element" in section 252(d)(1), this Court must choose

the more inclusive reading of the phrase that raises no constitutional difficulties. The fact that the FCC has chosen the narrow reading of "cost" as only "economic cost" should bear no weight in the Court's analysis. Federal courts do not defer to constitutionally problematic agency interpretations of statutes. Indeed, as this Court recently emphasized, "[w]here an administrative interpretation of a statute invokes the outer limits of Congress' power, we expect a clear indication that Congress intended that result." *Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683 (2001). In other words, there must be an exceedingly clear statement of *congressional* desire to test constitutional limits. *See id.* ("Congress does not casually authorize administrative agencies to interpret a statute to push the limit of congressional authority."); *NLRB v. Catholic Bishop*, 440 U.S. 490, 506-07 (1979). Thus, in order to sustain TELRIC, the FCC must demonstrate that Congress dictated the exclusion of historical costs from network-element prices. This is a burden that the agency cannot sustain. To the contrary, the FCC has stated that the statute "does not specify whether historical or embedded costs should be considered or whether only forward-looking costs should be considered" in setting prices for network elements. J.A. 398-99 (¶ 705). This concession precludes a finding of the kind of clarity demanded by *Solid Waste* and *Catholic Bishop*.

To sidestep the principle of constitutional avoidance, both the FCC and the court below have pointed to *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985), as if that case established some general exemption from the principle of avoidance whenever the constitutional issue at stake involves the Takings Clause. That is simply false. *See, e.g.*, *United States v. Security Indus. Bank*, 459 U.S. 70 (1982).

Riverside Bayview involved an agency interpretation of a statute that, even if applied, would not necessarily have effected a taking of property. The Court held only that a narrowing construction is not warranted if there is no "substantial argument" that application of a statute "will necessarily or even probably constitute a taking" in an "identifiable set of

instances." *Riverside Bayview*, 474 U.S. at 129 n.5. That analysis is inapposite here. Here, incumbents are being forced to turn over pieces of their networks to competitors, a requirement that plainly accomplishes a taking of their property. The only question is whether the rates paid by competitors will provide constitutionally sufficient compensation to ensure that there is not an *uncompensated* taking. Indeed, one factor driving the Court's analysis in *Riverside Bayview* – the availability of a Tucker Act proceeding to provide compensation for any taking – is particularly inapplicable here because Congress clearly intended network-element rates in themselves to provide compensation, not to create liability for the government under the Tucker Act. In a case such as this, as the D.C. Circuit has explained, a narrowing construction is demanded to ensure that the FCC does not "use statutory silence or ambiguity to expose the Treasury to liability both massive and unforeseen." *Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

III. THE FCC'S DECISION TO ABANDON HISTORICAL COSTS WAS CONTRARY TO THE PURPOSES OF THE ACT AND ARBITRARY AND CAPRICIOUS.

Apart from its constitutional infirmities, the FCC's resort to TELRIC rested on two fundamentally flawed determinations that undermined the purposes of the Act and that the FCC wholly failed to support with reasoned explanations.

A. Abandoning Historical Costs Frustrated Congressional Objectives and Was Not Supported By Any Rational Explanation.

For decades, historical costs have been used for determining the rates incumbent LECs receive for dedicating their property for public use. Indeed, the FCC itself has "strongly espoused" "the original-cost . . . principle of ratemaking . . . for many years." James C. Bonbright *et al.*, *Principles of Public Utility Rates* 212 (2d ed. 1988). Only two years before inventing TELRIC, in fact, the FCC had rejected a replacement cost methodology for cable television rates and explained that

"[o]riginal cost is the normal, now traditional method used for public utility valuation." *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Report & Order and Further Notice of Proposed Rulemaking, 9 F.C.C.R. 4527, 4555, ¶ 55 (1994). In that order, the FCC heaped criticisms upon replacement cost methodologies, charging that they are "speculative," "contentious," "unwieldy," "difficult to apply consistently," "likely to produce ratebase values that would not generate reasonable rates," "unworkable," and conducive to "a contentious exercise in competing opinions." *Id.* ¶¶ 55, 62.

Such criticisms are hardly new. Justice Brandeis long ago observed that replacement cost methodologies are administratively unworkable because they degenerate into battles between experts who give opinions "on things that never happened and estimates requiring the projection of the engineer's imagination into the future and methods of construction and installation that have never been and never will be adopted by sane men." *Missouri ex rel. Southwestern Bell Tel. v. Public Serv. Comm'n*, 262 U.S. 276, 300 (1923) (Brandeis, J., joined by Holmes, J., concurring); *see also* Hon. Stephen Breyer, *Regulation and Its Reform* 38-39 (1982) ("[T]o determine the replacement cost of a plant or equipment is too complex a task for an administrative process.").

The FCC's own experience abundantly confirms that TELRIC is an unmanageable project. In the parallel universal service proceeding, the agency repeatedly concluded that there simply were no cost models accurate enough to implement TELRIC. Only after *four years* of revising and updating various cost models did the agency finally decide that TELRIC could be used to project costs accurately. *See* Universal Service Order ¶¶ 244-245; *Federal-State Joint Board on Universal Service*, Fifth Report & Order, 13 F.C.C.R. 21,323, ¶¶ 3, 60 (1998). And even then the FCC was endorsing TELRIC solely for determining relative cost comparisons for purposes of federal universal service support, and admitted that figures from its TELRIC model "may not be appropriate . . . for other purposes, such as determining prices for unbundled

network elements." *See Federal-State Joint Board on Universal Service*, Ninth Report & Order, 14 F.C.C.R. 20,432, ¶ 41 & n. 125 (1999).

A novel cost measure that, if applied with any care, necessarily entails such difficulties in implementation frustrates one of the important objectives of the Act – namely, the "expeditious introduction of competition." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 425 (1999) (Breyer, J., concurring in part and dissenting in part). Congress made it clear that it intended the Act to be implemented swiftly. *See* 47 U.S.C. § 251(d)(1); *id.* § 252(b)(1), (e)(4). Saddling that process with the burdens of implementing a novel price measure such as TELRIC necessarily would frustrate the goal of speeding the transition to competition.

The same problems with TELRIC – *i.e.*, the abrupt change it entailed from the established historical cost methodology, the FCC's own criticisms of replacement-cost methodologies, and the agency's inability to find a satisfactory mechanism for implementing the cost measure for four years – also show that the agency was *at least* required to provide a cogent explanation for its decision to abandon historical costs in favor of TELRIC. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 57 (1983).

But the only reasons the agency gave were wholly inadequate. To start, the FCC's only stated reason for dismissing prior concerns about the workability of forward-looking cost measures was that "a number of states" had "already implemented" forward-looking measures for setting UNE prices. J.A. 381 (¶ 681). To the extent that the States cited had adopted forward-looking methodologies applicable to UNE pricing at all, they had done so in principle and had made little progress toward implementing the methodologies by determining costs. This dearth of real-world experience hardly provided a sound basis for the FCC to conclude that TELRIC was practicable.[18]

[18] *See, e.g.*, Bottleneck Servs. Establishment of a Framework for Network Architecture Development of Dominant Carrier Networks, Slip Op., R.93-04-003, I.93-04-002, Dec. 95-12-016, 62 CPUC2d 575 (Cal. PUC Dec. 6, 1995); *Proposed Rules Regarding Implementation of §§ 40-15-101 et seq. - Requirements Relating to Interconnection and Unbundling, Decision Adopting Rules*, Docket No. 95R-556T, Decision No. C96-347 (Colo. PUC Mar. 29, 1996).

The FCC also claimed that basing prices on incumbents' historical costs would promote "inefficient" entry because incumbents' costs reflected inefficiencies. But that assertion was wholly conclusory. Under prevailing regulations, incumbents' costs were either reviewed in the past to ensure that recovery was calibrated to prudent investments, or else they were regulated under price cap regimes that reduced rates according to projections of achievable efficiencies. In either case, simply assuming now that incumbents' costs are riddled with inefficiencies runs counter to the determinations inherent in the existing rate regime. The FCC cannot simply reject those determinations without providing any rationale for its change in course. Not only was such an approach arbitrary, but it also raises a serious due process concern, because changes in rate regimes that alter the basis for a firm's recovery demand procedural due process protections. *See, e.g., West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662 (1935).

Moreover, the agency's blithe assumptions about supposed incumbent inefficiency are inconsistent with the FCC's own contemporaneous position that price-cap regulation of rates was providing proper incentives for incumbents to operate efficiently. For a decade, the FCC has taken the view that it has been ensuring efficiency by reducing incumbents' rates by a productivity factor reflecting efficiency savings that reasonably could be achieved. Indeed, less than a year after announcing TELRIC, the FCC concluded that a rate reduction of 6.5 percent would reflect reasonable efficiency gains for incumbents. *See In re Price Cap Performance Review for Local Exchange Carriers*, Fourth Report & Order, 12 F.C.C.R. 16,642, ¶ 1 (1997), *rev'd in part, USTA v. FCC*, 188 F.3d 521, 526-27 (D.C. Cir. 1999) (striking down even 6.5% as

unjustifiedly high). That squarely contradicts the implication, inherent in the adoption of hypothetical TELRIC projections, that 50% discounts from incumbents' costs are necessary to reflect efficient levels.

B. The FCC's Effort To "Mimic" Competitive Outcomes Frustrates the Purposes of the Act.

The very goal the FCC set for itself in TELRIC – attempting to project the costs of an impossibly idealized, least-cost, most-efficient carrier – frustrated the objectives of the Act by short-circuiting the *process* of competition the Act was intended to set in motion. Congress envisioned a system in which entrants achieved efficiencies and introduced innovations that gradually created the genuine benefits of a competitive market, not a system that decreed the supposed benefits of competition (lower prices) by regulatory fiat. As Justice Breyer has noted:

> The competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any the less a regulatory process, nor any the more a competitive one.

AT&T Corp., 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part).

The FCC's economic rationales for TELRIC also suffered from further flaws. *First*, even if it were correct that prices should reflect an accurate measure of forward-looking costs, incumbents' historical costs – the amounts actually expended in building the network – are a far better measure of those costs than is TELRIC. As will be explained in our brief in response to the FCC's appeal in No. 00-587, TELRIC's false assumptions about how any market would work result in unrealistic projections even as a forward-looking cost methodology.

Second, the FCC provided no basis for its assertions that prices based on historical costs would foster "inefficient" entry. Beyond its unexplained assumption that incumbents were inefficient, the FCC offered no reason to explain why, even if

historical-cost prices were higher, inefficient competitors would be induced to enter the market. A potential entrant would evaluate its prospects of competing not only against the incumbent, but also against its best estimate of efficient competing entrants.

Third, the FCC ignored the threat to genuine competition from UNE prices that are too *low*. If prices are too low – as they are with TELRIC's unattainable assumptions – network elements become an irresistible option for entrants and will choke off facilities-based entry. It would be irrational for entrants to deploy new facilities if they could purchase UNEs at prices below any costs they could hope to achieve.

Finally, as Professor Kahn has explained, the FCC ignored a further compelling efficiency reason for *retaining* the historical-cost method: "Entirely apart from the inescapable question of equity that [denying recovery of historical costs] would raise, it is a reasonable economic (as well, perhaps, as constitutional) question whether a market system can survive if governments feel free opportunistically to change the rules of the regulatory game at the expense of investors, when it is temporarily to the advantage of consumers to do so." Declaration of Alfred E. Kahn and Timothy J. Tardiff, ¶ 13, J.A. 160-61, submitted with Reply Comments of Bell Atlantic, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 30, 1996). Investments made today under a TELRIC pricing regime will become tomorrow's sunk, historical investments, and as one of AT&T's own economists concedes, the failure to allow recovery of stranded historical costs can produce "disincentive[s] for future investment." William J. Baumol & J. Gregory Sidak, *Stranded Costs*, 18 Harv. J.L. & Pub. Pol'y 835, 836 (1995).

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed insofar as it permitted the FCC to preclude recovery of historical costs under section 252(d)(1).

Respectfully submitted,

MARK L. EVANS
MICHAEL K. KELLOGG
HENK BRANDS
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1650 M Street, N.W.
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Rd.
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

ANDREW G. MCBRIDE
SCOTT DELACOURT
WILEY, REIN & FIELDING
1776 K STREET, N.W.
WASHINGTON, D.C. 20006
(202) 719-7135

HENRY WEISSMANN
MUNGER, TOLLES &
OLSON LLP
355 SOUTH GRAND AVENUE
LOS ANGELES, CA 90071
(213) 683-9100

Counsel for Verizon Entities

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, Texas 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM
ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States Telecom Association

April 9, 2001

ADDENDUM

ADDENDUM CONTENTS

47 U.S.C. § 251 ..... 1a-9a

47 U.S.C. § 252 ..... 9a-18a

47 U.S.C. § 253 ..... 18a-19a

47 U.S.C. § 254 ..... 19a-27a

47 C.F.R. § 51.501 ..... 28a

47 C.F.R. § 51.503 ..... 28a

47 C.F.R. § 51.505 ..... 28a-31a

47 C.F.R. § 51.507 ..... 31a-32a

47 C.F.R. § 51.509 ..... 32a-33a

47 C.F.R. § 51.511 ..... 33a-34a

SEC. 251. [47 U.S.C. 251] INTERCONNECTION.

(a) GENERAL DUTY OF TELECOMMUNICATIONS CARRIERS.–Each telecommunications carrier has the duty–

(1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and

(2) not to install network features, functions, or capabilities that do not comply with the guidelines and standards established pursuant to section 255 or 256.

(b) OBLIGATIONS OF ALL LOCAL EXCHANGE CARRIERS.–Each local exchange carrier has the following duties:

(1) RESALE.–The duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services.

(2) NUMBER PORTABILITY.–The duty to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission.

(3) DIALING PARITY.–The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

(4) ACCESS TO RIGHTS-OF-WAY.–The duty to afford access to the poles, ducts, conduits, and rights-of-way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224.

(5) RECIPROCAL COMPENSATION.–The duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

(c) ADDITIONAL OBLIGATIONS OF INCUMBENT LOCAL EXCHANGE CARRIERS.–In addition to the duties contained in subsection (b), each incumbent local exchange carrier has the following duties:

(1) DUTY TO NEGOTIATE.–The duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) and this subsection. The requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements.

(2) INTERCONNECTION.–The duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network–

(A) for the transmission and routing of telephone exchange service and exchange access;

(B) at any technically feasible point within the carrier's network;

(C) that is at least equal in quality to that provided by the local exchange carrier to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection; and

(D) on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252.

(3) UNBUNDLED ACCESS.–The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

(4) RESALE.–The duty–

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

(5) NOTICE OF CHANGES.–The duty to provide reasonable public notice of changes in the information necessary for the transmission and routing of services using that local exchange carrier's facilities or networks, as well as of any other changes that would

affect the interoperability of those facilities and networks.

(6) COLLOCATION.–The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

(d) IMPLEMENTATION.–

(1) IN GENERAL.–Within 6 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall complete all actions necessary to establish regulations to implement the requirements of this section.

(2) ACCESS STANDARDS.–In determining what network elements should be made available for purposes of subsection (c)(3), the Commission shall consider, at a minimum, whether–

(A) access to such network elements as are proprietary in nature is necessary; and

(B) the failure to provide access to such network elements would impair the ability of the telecommunications carriers seeking access to provide the services that it seeks to offer.

(3) PRESERVATION OF STATE ACCESS REGULATIONS.–In prescribing and enforcing regulations to implement the requirements of this section, the Commission shall not preclude the enforcement of any regulation, order, or policy of a State commission that–

(A) establishes access and interconnection obligations of local exchange carriers;

(B) is consistent with the requirements of this section; and

(C) does not substantially prevent implementation of the requirements of this section and the purposes of this part.

(e) NUMBERING ADMINISTRATION.–

(1) COMMISSION AUTHORITY AND JURISDICTION.–The Commission shall create or designate one or more impartial entities to administer telecommunications numbering and to make such numbers available on an equitable basis. The Commission shall have exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States. Nothing in this paragraph shall preclude the Commission from delegating to State commissions or other entities all or any portion of such jurisdiction.

(2) COSTS.–The cost of establishing telecommunications numbering administration arrangements and number portability shall be borne by all telecommunications carriers on a competitively neutral basis as determined by the Commission.

(f) EXEMPTIONS, SUSPENSIONS, AND MODIFICATIONS.–

(1) EXEMPTION FOR CERTAIN RURAL TELEPHONE COMPANIES.–

(A) EXEMPTION.–Subsection (c) of this section shall not apply to a rural telephone company until (i) such company has received a bona fide request for interconnection, services, or network elements, and (ii) the State commission determines (under subparagraph

(B)) that such request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof).

(B) STATE TERMINATION OF EXEMPTION AND IMPLEMENTATION SCHEDULE.–The party making a bona fide request of a rural telephone company for interconnection, services, or network elements shall submit a notice of its request to the State commission. The State commission shall conduct an inquiry for the purpose of determining whether to terminate the exemption under subparagraph (A). Within 120 days after the State commission receives notice of the request, the State commission shall terminate the exemption if the request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof). Upon termination of the exemption, a State commission shall establish an implementation schedule for compliance with the request that is consistent in time and manner with Commission regulations.

(C) LIMITATION ON EXEMPTION.–The exemption provided by this paragraph shall not apply with respect to a request under subsection (c) from a cable operator providing video programming, and seeking to provide any telecommunications service, in the area in which the rural telephone company provides video programming. The limitation contained in this subparagraph shall not apply to a rural

telephone company that is providing video programming on the date of enactment of the Telecommunications Act of 1996.

(2) SUSPENSIONS AND MODIFICATIONS FOR RURAL CARRIERS.–A local exchange carrier with fewer than 2 percent of the Nation's subscriber lines installed in the aggregate nationwide may petition a State commission for a suspension or modification of the application of a requirement or requirements of subsection (b) or (c) to telephone exchange service facilities specified in such petition. The State commission shall grant such petition to the extent that, and for such duration as, the State commission determines that such suspension or modification–

(A) is necessary–

(i) to avoid a significant adverse economic impact on users of telecommunications services generally;

(ii) to avoid imposing a requirement that is unduly economically burdensome; or

(iii) to avoid imposing a requirement that is technically infeasible; and

(B) is consistent with the public interest, convenience, and necessity.

The State commission shall act upon any petition filed under this paragraph within 100 days after receiving such petition. Pending such action, the State commission may suspend enforcement of the requirement or requirements to which the petition applies with respect to the petitioning carrier or carriers.

(g) CONTINUED ENFORCEMENT OF EXCHANGE ACCESS AND INTERCONNECTION REQUIREMENTS.–On and after the date

of enactment of the Telecommunications Act of 1996, each local exchange carrier, to the extent that it provides wireline services, shall provide exchange access information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) that apply to such carrier on the date immediately preceding the date of enactment of the Telecommunications Act of 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment. During the period beginning on such date of enactment and until such restrictions and obligations are so superseded, such restrictions and obligations shall be enforceable in the same manner as regulations of the Commission.

(h) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER.–

(1) DEFINITION.–For purposes of this section, the term "incumbent local exchange carrier" means, with respect to an area, the local exchange carrier that–

(A) on the date of enactment of the Telecommunications Act of 1996, provided telephone exchange service in such area; and

(B)(i) on such date of enactment, was deemed to be a member of the exchange carrier association pursuant to section 69.601(b) of the Commission's regulations (47 C.F.R. 69.601(b)); or

(ii) is a person or entity that, on or after such date of enactment, became a successor or assign of a member described in clause (i).

(2) TREATMENT OF COMPARABLE CARRIERS AS INCUMBENTS.–The Commission may, by rule, provide for treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if–

(A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1);

(B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and

(C) such treatment is consistent with the public interest, convenience, and necessity and the purposes of this section.

(i) SAVINGS PROVISION.–Nothing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201.

SEC. 252. [47 U.S.C. 252] PROCEDURES FOR NEGOTIATION, ARBITRATION, AND APPROVAL OF AGREEMENTS.

(a) AGREEMENTS ARRIVED AT THROUGH NEGOTIATION.–

(1) VOLUNTARY NEGOTIATIONS.–Upon receiving a request for interconnection, services, or network elements pursuant to section 251, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251. The agreement shall include a detailed schedule of itemized charges for interconnection and

each service or network element included in the agreement. The agreement, including any interconnection agreement negotiated before the date of enactment of the Telecommunications Act of 1996, shall be submitted to the State commission under subsection (e) of this section.

(2) MEDIATION.–Any party negotiating an agreement under this section may, at any point in the negotiation, ask a State commission to participate in the negotiation and to mediate any differences arising in the course of the negotiation.

(b) AGREEMENTS ARRIVED AT THROUGH COMPULSORY ARBITRATION.–

(1) ARBITRATION.–During the period from the 135th to the 160th day (inclusive) after the date on which an incumbent local exchange carrier receives a request for negotiation under this section, the carrier or any other party to the negotiation may petition a State commission to arbitrate any open issues.

(2) DUTY OF PETITIONER.–

(A) A party that petitions a State commission under paragraph (1) shall, at the same time as it submits the petition, provide the State commission all relevant documentation concerning–

(i) the unresolved issues;

(ii) the position of each of the parties with respect to those issues; and

(iii) any other issue discussed and resolved by the parties.

(B) A party petitioning a State commission under paragraph (1) shall provide a copy of the petition and any documentation to the other party or parties not later than the day

on which the State commission receives the petition.

(3) OPPORTUNITY TO RESPOND.–A non-petitioning party to a negotiation under this section may respond to the other party's petition and provide such additional information as it wishes within 25 days after the State commission receives the petition.

(4) ACTION BY STATE COMMISSION.–

(A) The State commission shall limit its consideration of any petition under paragraph (1) (and any response thereto) to the issues set forth in the petition and in the response, if any, filed under paragraph (3).

(B) The State commission may require the petitioning party and the responding party to provide such information as may be necessary for the State commission to reach a decision on the unresolved issues. If any party refuses or fails unreasonably to respond on a timely basis to any reasonable request from the State commission, then the State commission may proceed on the basis of the best information available to it from whatever source derived.

(C) The State commission shall resolve each issue set forth in the petition and the response, if any, by imposing appropriate conditions as required to implement subsection (c) upon the parties to the agreement, and shall conclude the resolution of any unresolved issues not later than 9 months after the date on which the local exchange carrier received the request under this section.

(5) REFUSAL TO NEGOTIATE.–The refusal of any other party to the negotiation to participate further in the

negotiations, to cooperate with the State commission in carrying out its function as an arbitrator, or to continue to negotiate in good faith in the presence, or with the assistance, of the State commission shall be considered a failure to negotiate in good faith.

(c) STANDARDS FOR ARBITRATION.–In resolving by arbitration under subsection (b) any open issues and imposing conditions upon the parties to the agreement, a State commission shall–

(1) ensure that such resolution and conditions meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251;

(2) establish any rates for interconnection, services, or network elements according to subsection (d); and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.

(d) PRICING STANDARDS.–

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES.–Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section–

(A) shall be–

(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

(2) CHARGES FOR TRANSPORT AND TERMINATION OF TRAFFIC.–

(A) IN GENERAL.–For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless–

(i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

(ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls.

(B) RULES OF CONSTRUCTION.–This paragraph shall not be construed–

(i) to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements); or

(ii) to authorize the Commission or any State commission to engage in any rate regulation proceeding to establish with particularity the

additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls.

(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES.–For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunication service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

(e) APPROVAL BY STATE COMMISSION.–

(1) APPROVAL REQUIRED.–Any interconnection agreement adopted by negotiation or arbitration shall be submitted for approval to the State commission. A State commission to which anagreement is submitted shall approve or reject the agreement, with written findings as to any deficiencies.

(2) GROUNDS FOR REJECTION.–The State commission may only reject–

(A) an agreement (or any portion thereof) adopted by negotiation under subsection (a) if it finds that–

(i) the agreement (or portion thereof) discriminates against a telecommunications carrier not a party to the agreement; or

(ii) the implementation of such agreement or portion is not consistent with the public interest, convenience, and necessity; or

(B) an agreement (or any portion thereof) adopted by arbitration under subsection

(b) if it finds that the agreement does not meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251, or the standards set forth in subsection (d) of this section.

(3) PRESERVATION OF AUTHORITY.–Notwithstanding paragraph (2), but subject to section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of an agreement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(4) SCHEDULE FOR DECISION.–If the State commission does not act to approve or reject the agreement within 90 days after submission by the parties of an agreement adopted by negotiation under subsection (a), or within 30 days after submission by the parties of an agreement adopted by arbitration under subsection (b), the agreement shall be deemed approved. No State court shall have jurisdiction to review the action of a State commission in approving or rejecting an agreement under this section.

(5) COMMISSION TO ACT IF STATE WILL NOT ACT.–If a State commission fails to act to carry out its responsibility under this section in any proceeding or other matter under this section, then the Commission shall issue an order preempting the State commission's jurisdiction of that proceeding or matter within 90 days after being notified (or taking notice) of such failure, and shall assume the responsibility of the State commission under this section with respect to the proceeding or matter and act for the State commission.

(6) REVIEW OF STATE COMMISSION ACTIONS.–In a case in which a State fails to act as described in paragraph (5), the proceeding by the Commission under such paragraph and any judicial review of the Commission's actions shall be the exclusive remedies for a State commission's failure to act. In any case in which a State commission makes a determination under this section, any party aggrieved by such determination may bring an action in an appropriate Federal district court to determine whether the agreement or statement meets the requirements of section 251 and this section.

(f) STATEMENTS OF GENERALLY AVAILABLE TERMS.–

(1) IN GENERAL.–A Bell operating company may prepare and file with a State commission a statement of the terms and conditions that such company generally offers within that State to comply with the requirements of section 251 and the regulations thereunder and the standards applicable under this section.

(2) STATE COMMISSION REVIEW.–A State commission may not approve such statement unless such statement complies with subsection (d) of this section and section 251 and the regulations thereunder. Except as provided in section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of such statement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(3) SCHEDULE FOR REVIEW.–The State commission to which a statement is submitted shall, not later than 60 days after the date of such submission–

(A) complete the review of such statement under paragraph (2) (including any reconsideration thereof), unless the submitting

carrier agrees to an extension of the period for such review; or

(B) permit such statement to take effect.

(4) AUTHORITY TO CONTINUE REVIEW.–Paragraph (3) shall not preclude the State commission from continuing to review a statement that has been permitted to take effect under subparagraph (B) of such paragraph or from approving or disapproving such statement under paragraph (2).

(5) DUTY TO NEGOTIATE NOT AFFECTED.–The submission or approval of a statement under this subsection shall not relieve a Bell operating company of its duty to negotiate the terms and conditions of an agreement under section 251.

(g) CONSOLIDATION OF STATE PROCEEDINGS.–Where not inconsistent with the requirements of this Act, a State commission may, to the extent practical, consolidate proceedings under sections 214(e), 251(f), 253, and this section in order to reduce administrative burdens on telecommunications carriers, other parties to the proceedings, and the State commission in carrying out its responsibilities under this Act.

(h) FILING REQUIRED.–A State commission shall make a copy of each agreement approved under subsection (e) and each statement approved under subsection (f) available for public inspection and copying within 10 days after the agreement or statement is approved. The State commission may charge a reasonable and nondiscriminatory fee to the parties to the agreement or the party filing the statement to cover the costs of approving and filing such agreement or statement.

(i) AVAILABILITY TO OTHER TELECOMMUNICATIONS CARRIERS.–A local exchange carrier shall make available any interconnection, service, or network element provided under an

agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.

(j) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER.–For purposes of this section, the term "incumbent local exchange carrier" has the meaning provided in section 251(h).

SEC. 253. [47 U.S.C. 253] REMOVAL OF BARRIERS TO ENTRY.

(a) IN GENERAL.–No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.

(b) STATE REGULATORY AUTHORITY.–Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with section 254 of this section, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.

(c) STATE AND LOCAL GOVERNMENT AUTHORITY.–Nothing in this section affects the authority of a State or local government to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers, on a competitively neutral and nondiscriminatory basis, for use of public rights-of-way on a nondiscriminatory basis, if the compensation required is publicly disclosed by such government.

(d) PREEMPTION.–If, after notice and an opportunity for public comment, the Commission determines that a State or local government has permitted or imposed any statute, regulation, or legal requirement that violates subsection (a) or

(b) of this section, the Commission shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency.

(e) COMMERCIAL MOBILE SERVICE PROVIDERS.–Nothing in this section shall affect the application of section 332(c)(3) of this title to commercial mobile service providers.

(f) RURAL MARKETS.–It shall not be a violation of this section for a State to require a telecommunications carrier that seeks to provide telephone exchange service or exchange access in a service area served by a rural telephone company to meet the requirements in section 214(e)(1) of this title for designation as an eligible telecommunications carrier for that area before being permitted to provide such service. This subsection shall not apply–

(1) to a service area served by a rural telephone company that has obtained an exemption, suspension, or modification of section 251(c)(4) of this title that effectively prevents a competitor from meeting the requirements of section 214(e)(1) of this title; and

(2) to a provider of commercial mobile services.

SEC. 254. [47 U.S.C. 254] UNIVERSAL SERVICE.

(a) PROCEDURES TO REVIEW UNIVERSAL SERVICE REQUIREMENTS.–

(1) FEDERAL-STATE JOINT BOARD ON UNIVERSAL SERVICE.–Within one month after February 8, 1996, the Commission shall institute and refer to a Federal-State Joint Board under section 410(c) of this title a proceeding to recommend changes to any of its regulations in order to implement sections 214(e) of this title and this section, including the definition of the services that are supported by Federal universal service

support mechanisms and a specific timetable for completion of such recommendations. In addition to the members of the Joint Board required under section 410(c) of this title, one member of such Joint Board shall be a State-appointed utility consumer advocate nominated by a national organization of State utility consumer advocates. The Joint Board shall, after notice and opportunity for public comment, make its recommendations to the Commission 9 months after February 8, 1996.

(2) COMMISSION ACTION.–The Commission shall initiate a single proceeding to implement the recommendations from the Joint Board required by paragraph (1) and shall complete such proceeding within 15 months after February 8, 1996. The rules established by such proceeding shall include a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation. Thereafter, the Commission shall complete any proceeding to implement subsequent recommendations from any Joint Board on universal service within one year after receiving such recommendations.

(b) UNIVERSAL SERVICE PRINCIPLES.–The Joint Board and the Commission shall base policies for the preservation and advancement of universal service on the following principles:

(1) QUALITY AND RATES.–Quality services should be available at just, reasonable, and affordable rates.

(2) ACCESS TO ADVANCED SERVICES.–Access to advanced telecommunications and information services should be provided in all regions of the Nation.

(3) ACCESS IN RURAL AND HIGH COST AREAS.–Consumers in all regions of the Nation, including low-

income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

(4) EQUITABLE AND NONDISCRIMINATORY CONTRIBUTIONS.–All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service.

(5) SPECIFIC AND PREDICTABLE SUPPORT MECHANISMS.–There should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service.

(6) ACCESS TO ADVANCED TELECOMMUNICATIONS SERVICES FOR SCHOOLS, HEALTH CARE, AND LIBRARIES.–Elementary and secondary schools and classrooms, health care providers, and libraries should have access to advanced telecommunications services as described in subsection (h) of this section.

(7) ADDITIONAL PRINCIPLES.–Such other principles as the Joint Board and the Commission determine are necessary and appropriate for the protection of the public interest, convenience, and necessity and are consistent with this chapter.

(c) DEFINITION.–

(1) IN GENERAL.–Universal service is an evolving level of telecommunications services that the Commission shall establish periodically under this section, taking into account advances in

telecommunications and information technologies and services. The Joint Board in recommending, and the Commission in establishing, the definition of the services that are supported by Federal universal service support mechanisms shall consider the extent to which such telecommunications services–

(A) are essential to education, public health, or public safety;

(B) have, through the operation of market choices by customers, been subscribed to by a substantial majority of residential customers;

(C) are being deployed in public telecommunications networks by telecommunications carriers; and

(D) are consistent with the public interest, convenience, and necessity.

(2) ALTERATIONS AND MODIFICATIONS.–The Joint Board may, from time to time, recommend to the Commission modifications in the definition of the services that are supported by Federal universal service support mechanisms.

(3) SPECIAL SERVICES.–In addition to the services included in the definition of universal service under paragraph (1), the Commission may designate additional services for such support mechanisms for schools, libraries, and health care providers for the purposes of subsection (h) of this section.

(d) TELECOMMUNICATIONS CARRIER CONTRIBUTION.–Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service. The

Commission may exempt a carrier or class of carriers from this requirement if the carrier's telecommunications activities are limited to such an extent that the level of such carrier's contribution to the preservation and advancement of universal service would be de minimis. Any other provider of interstate telecommunications may be required to contribute to the preservation and advancement of universal service if the public interest so requires.

(e) UNIVERSAL SERVICE SUPPORT.–After the date on which Commission regulations implementing this section take effect, only an eligible telecommunications carrier designated under section 214(e) of this title shall be eligible to receive specific Federal universal service support. A carrier that receives such support shall use that support only for the provision, maintenance, and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purposes of this section.

(f) STATE AUTHORITY.–A State may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State. A State may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitions or standards that do not rely on or burden Federal universal service support mechanisms.

(g) INTEREXCHANGE AND INTERSTATE SERVICES.–Within 6 months after February 8, 1996, the Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to

subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State.

(h) TELECOMMUNICATIONS SERVICES FOR CERTAIN PROVIDERS.–

(1) IN GENERAL.–

(A) HEALTH CARE PROVIDERS FOR RURAL AREAS.–A telecommunications carrier shall, upon receiving a bona fide request, provide telecommunications services which are necessary for the provision of health care services in a State, including instruction relating to such services, to any public or nonprofit health care provider that serves persons who reside in rural areas in that State at rates that are reasonably comparable to rates charged for similar services in urban areas in that State. A telecommunications carrier providing service under this paragraph shall be entitled to have an amount equal to the difference, if any, between the rates for services provided to health care providers for rural areas in a State and the rates for similar services provided to other customers in comparable rural areas in that State treated as a service obligation as a part of its obligation to participate in the mechanisms to preserve and advance universal service.

(B) EDUCATIONAL PROVIDERS AND LIBRARIES.–All telecommunications carriers serving a geographic area shall, upon a bona

fide request for any of its services that are within the definition of universal service under subsection (c)(3) of this section, provide such services to elementary schools, secondary schools, and libraries for educational purposes at rates less than the amounts charged for similar services to other parties. The discount shall be an amount that the Commission, with respect to interstate services, and the States, with respect to intrastate services, determine is appropriate and necessary to ensure affordable access to and use of such services by such entities. A telecommunications carrier providing service under this paragraph shall–

(i) have an amount equal to the amount of the discount treated as an offset to its obligation to contribute to the mechanisms to preserve and advance universal service, or

(ii) notwithstanding the provisions of subsection (e) of this section, receive reimbursement utilizing the support mechanisms to preserve and advance universal service.

(2) ADVANCED SERVICES.–The Commission shall establish competitively neutral rules–

(A) to enhance, to the extent technically feasible and economically reasonable, access to advanced telecommunications and information services for all public and nonprofit elementary and secondary school classrooms, health care providers, and libraries; and

(B) to define the circumstances under which a tele-communications carrier may be

required to connect its network to such public institutional telecommunications users.

(3) TERMS AND CONDITIONS.–Telecommunications services and network capacity provided to a public institutional telecommunications user under this subsection may not be sold, resold, or otherwise transferred by such user in consideration for money or any other thing of value.

(4) ELIGIBILITY OF USERS.–No entity listed in this subsection shall be entitled to preferential rates or treatment as required by this subsection, if such entity operates as a for-profit business, is a school described in paragraph (5)(A) with an endowment of more than $50,000,000, or is a library or library consortium not eligible for assistance from a State library administrative agency under the Library Services and Technology Act.

(5) DEFINITIONS.–For purposes of this subsection:

(A) ELEMENTARY AND SECONDARY SCHOOLS.–The term "elementary and secondary schools" means elementary schools and secondary schools, as defined in paragraphs (14) and (25), respectively, of section 8801 of Title 20.

(B) HEALTH CARE PROVIDER.–The term "health care provider" means–

(i) post-secondary educational institutions offering health care instruction, teaching hospitals, and medical schools;

(ii) community health centers or health centers providing health care to migrants;

(iii) local health departments or agencies;

(iv) community mental health centers;

(v) not-for-profit hospitals;

(vi) rural health clinics; and

(vii) consortia of health care providers consisting of one or more entities described in clauses (i) through (vi).

(C) PUBLIC INSTITUTIONAL TELECOMMUNICATIONS USER.–The term "public institutional telecommunications user" means an elementary or secondary school, a library, or a health care provider as those terms are defined in this paragraph.

(i) CONSUMER PROTECTION.–The Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable.

(j) LIFELINE ASSISTANCE.–Nothing in this section shall affect the collection, distribution, or administration of the Lifeline Assistance Program provided for by the Commission under regulations set forth in section 69.117 of title 47, Code of Federal Regulations, and other related sections of such title.

(k) SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.–A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

47 C.F.R. § 51.501 Scope.

(a) The rules in this subpart apply to the pricing of network elements, interconnection, and methods of obtaining access to unbundled elements, including physical collocation and virtual collocation.
(b) As used in this subpart, the term "element" includes network elements, interconnection, and methods of obtaining interconnection and access to unbundled elements.

47 C.F.R. § 51.503 General pricing standard.

(a) An incumbent LEC shall offer elements to requesting telecommunications carriers at rates, terms, and conditions that are just, reasonable, and nondiscriminatory.
(b) An incumbent LEC's rates for each element it offers shall comply with the rate structure rules set forth in §§ 51.507 and 51.509, and shall be established, at the election of the state commission-

(1) Pursuant to the forward-looking economic cost-based pricing methodology set forth in §§ 51.505 and 51.511; or

(2) Consistent with the proxy ceilings and ranges set forth in § 51.513.
(c) The rates that an incumbent LEC assesses for elements shall not vary on the basis of the class of customers served by the requesting carrier, or on the type of services that the requesting carrier purchasing such elements uses them to provide.

47 C.F.R. § 51.505 Forward-looking economic cost.

(a) In general. The forward-looking economic cost of an element equals the sum of:

(1) The total element long-run incremental cost of the element, as described in paragraph (b); and

(2) A reasonable allocation of forward-looking common costs, as described in paragraph (c).
(b) Total element long-run incremental cost. The total element long-run incremental cost of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(1) Efficient network configuration. The total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

(2) Forward-looking cost of capital. The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element.

(3) Depreciation rates. The depreciation rates used in calculating forward- looking economic costs of elements shall be economic depreciation rates.
(c) Reasonable allocation of forward-looking common costs--

(1) Forward-looking common costs. Forward-looking common costs are economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent LEC) that cannot be attributed directly to individual elements or services.

(2) Reasonable allocation.

(i) The sum of a reasonable allocation of forward-looking common costs and the total element long-run incremental cost of an element shall not exceed the stand-alone costs associated with the element. In this context, stand-alone costs are the total

forward-looking costs, including corporate costs, that would be incurred to produce a given element if that element were provided by an efficient firm that produced nothing but the given element.

(ii) The sum of the allocation of forward-looking common costs for all elements and services shall equal the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LEC's total network, so as to provide all the elements and services offered.

(d) Factors that may not be considered. The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:

(1) Embedded costs. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts;

(2) Retail costs. Retail costs include the costs of marketing, billing, collection, and other costs associated with offering retail telecommunications services to subscribers who are not telecommunications carriers, described in § 51.609;

(3) Opportunity costs. Opportunity costs include the revenues that the incumbent LEC would have received for the sale of telecommunications services, in the absence of competition from telecommunications carriers that purchase elements; and

(4) Revenues to subsidize other services. Revenues to subsidize other services include revenues associated with elements or telecommunications service offerings other than the element for which a rate is being established.

(e) Cost study requirements. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward- looking economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511.

(1) A state commission may set a rate outside the proxy ranges or above the proxy ceilings described in § 51.513 only if that commission has given full and fair effect to the economic cost based pricing methodology described in this section and § 51.511 in a state proceeding that meets the requirements of paragraph (e)(2) of this section.

(2) Any state proceeding conducted pursuant to this section shall provide notice and an opportunity for comment to affected parties and shall result in the creation of a written factual record that is sufficient for purposes of review. The record of any state proceeding in which a state commission considers a cost study for purposes of establishing rates under this section shall include any such cost study.

47 C.F.R. § 51.507 <u>General rate structure standard</u>.

(a) Element rates shall be structured consistently with the manner in which the costs of providing the elements are incurred.

(b) The costs of dedicated facilities shall be recovered through flat-rated charges.

(c) The costs of shared facilities shall be recovered in a manner that efficiently apportions costs among users. Costs of shared facilities may be apportioned either through usage-sensitive charges or capacity-based flat-rated charges, if the state commission finds that such rates reasonably reflect the costs imposed by the various users.

(d) Recurring costs shall be recovered through recurring charges, unless an incumbent LEC proves to a state commission that such recurring costs are de minimis. Recurring costs shall be considered de minimis when the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

(e) State commissions may, where reasonable, require incumbent LECs to recover nonrecurring costs through recurring charges over a reasonable period of time. Nonrecurring charges shall be allocated efficiently among requesting telecommunications carriers, and shall not permit an incumbent LEC to recover more than the total forward-looking economic cost of providing the applicable element.
(f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.

(1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in § 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.

(2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

47 C.F.R § 51.509 Rate structure standards for specific elements.

In addition to the general rules set forth in § 51.507, rates for specific elements shall comply with the following rate structure rules.
(a) Local loops. Loop costs shall be recovered through flat-rated charges.
(b) Local switching. Local switching costs shall be recovered through a combination of a flat-rated charge for line ports and one or more flat-rated or per-minute usage charges for the switching matrix and for trunk ports.
(c) Dedicated transmission links. Dedicated transmission link costs shall be recovered through flat-rated charges.
(d) Shared transmission facilities between tandem switches and end offices. The costs of shared transmission facilities between

tandem switches and end offices may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(e) Tandem switching. Tandem switching costs may be recovered through usage- sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(f) Signaling and call-related database services. Signaling and call-related database service costs shall be usage-sensitive, based on either the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, the cost of which shall be recovered through flat- rated charges.
(g) Collocation. Collocation costs shall be recovered consistent with the rate structure policies established in the Expanded Interconnection proceeding, CC Docket No. 91-141.

47 C.F.R. § 51.511 Forward-looking economic cost per unit.

(a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.
(b)(1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the discrete number of elements (e.g., local loops or local switch ports) that the incumbent LEC uses or provides.
(2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the

unit of measurement of the usage (e.g., minutes of use or call-related database queries) of the element.

APR 9 2001

No. 00-590, 00-511, 00-555, 00-587, 00-602

Supreme Court, U.S.
FILED
APR 9 2001
CLERK

IN THE

Supreme Court of the United States

AT&T CORP.,

Petitioner,

v.

IOWA UTILITIES BOARD, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF PETITIONER AT&T CORP.

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY AUSTIN BROWN & WOOD
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner

* Counsel of Record

April 9, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

56 pp

QUESTIONS PRESENTED

1. Whether the court of appeals erred in holding that 47 U.S.C. § 252(d)(1) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies?

2. Whether the court of appeals erred in holding that 47 U.S.C. § 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task?

LIST OF PARTIES AND AFFILIATES

The parties to the proceedings in the Eighth Circuit are listed in Appendix A and Appendix D of AT&T's Petition for Certiorari at 1a and 222a-224a.

Pursuant to Supreme Court Rule 29.6, petitioner states as follows: AT&T provides telecommunications, cable, and other services. AT&T has no parent company. No publicly held company owns more than 10 percent of AT&T's stock.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
LIST OF PARTIES AND AFFILIATES	ii
TABLE OF AUTHORITIES	v
OPINION BELOW	1
JURISDICTION	1
STATUTORY PROVISIONS	1
STATEMENT OF THE CASE	1
1. Local Service And Its Natural Monopoly And Other Characteristics	3
2. The Monopoly Era Regulation Of LECs' Local And Long Distance Services	5
3. The Regulations Adopted To Allow Competition In Long Distance And Other Telephone Services	6
4. The 1996 Act And The Ensuing Proceedings	12
5. The Eighth Circuit's Decision On Remand	21
SUMMARY OF ARGUMENT	22
ARGUMENT	25
I. TELRIC IS A REASONABLE METHOD OF IMPLEMENTING THE MANDATE THAT INTERCONNECTION AND NETWORK ELEMENT RATES BE BASED ON THE COST OF PROVIDING THEM	25

TABLE OF CONTENTS – continued

	Page
A. TELRIC Determines The Costs Of Providing The LECs' "Actual Facilities"	28
B. The Eighth Circuit Misconstrued § 251(d)(1)	34
C. The Eighth Circuit's Decision Would Require Ratemaking Methods That Either Irrationally Inflate Rates Well Above TELRIC Or Require Rates Far Below TELRIC	37
II. THE NETWORK ELEMENT COMBINATIONS RULE IS VALID	40
CONCLUSION	46

TABLE OF AUTHORITIES

CASES Page

AT&T Corp. v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999) ..... *passim*
Barry Wright Corp. v. *ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983) 8
Chevron, U.S.A., Inc. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) .. 23, 25, 27, 34, 37
Consolidated Rail Corp. v. *United States*, 812 F.2d 1444 (3d Cir. 1987) 32
Duquesne Light Co. v. *Barasch*, 488 U.S. 299 (1989) 31, 32
FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) 5, 31
FPC v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942) 34
Haggar Co. v. *Helvering*, 308 U.S. 389 (1940) 36
Iowa Utils. Bd. v. *FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part, rev'd in part*, 525 U.S. 366 (1999) 41, 42, 43, 45
Kmart Corp. v. *Cartier, Inc.*, 486 U.S. 281 (1988) 23
Litton Sys., Inc. v. *AT&T*, 700 F.2d 785 (2d Cir. 1983) 10
Louisiana Pub. Serv. Comm'n v. *FCC*, 476 U.S. 355 (1986) 5
MCI Communications Corp. v. *AT&T*, 708 F.2d 1081 (7th Cir. 1983) 8, 29, 30
MCI Telecomm. Corp. v. *FCC*, 712 F.2d 517 (D.C. Cir. 1983) 10
Missouri ex rel. Southwestern Bell Tel. Co. v. *Pub. Serv. Comm'n*, 262 U.S. 276 (1923) 24, 39
Mobil Oil Corp. v. *FPC*, 417 U.S. 283 (1974) 34
Mobil Oil Exploration & Producing Southeast Inc. v. *United Distribution Cos.*, 498 U.S. 211 (1991) 32

TABLE OF AUTHORITIES – continued

	Page
Northeastern Tel. Co. v. *AT&T*, 651 F.2d 76 (2d Cir. 1981)	8, 30
National Ass'n of Greeting Card Publishers v. *United States Postal Serv.*, 462 U.S. 810 (1983)	29
Potomac Elec. Power Co. v. *ICC*, 744 F.2d 185 (D.C. Cir. 1984)	32
Strickland v. *Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12 (1st Cir. 1995)	29
Texas Office of Pub. Util. Counsel v. *FCC*, 183 F.3d 393 (5th Cir. 1999), *cert. denied*, 120 S. Ct. 2212, 2237 (2000) (Nos. 99-1072, 99-1249), *cert. dismissed*, 121 S. Ct. 423 (2000) (No. 99-1244)	20
U S West Communications v. *MFS Intelenet, Inc.*, 193 F.3d 1112 (9th Cir. 1999), *cert. denied*, 120 S. Ct. 2741 (2000)	40
United States v. *AT&T*, 524 F. Supp. 1336 (D.D.C. 1981)	9
United States v. *AT&T*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd*, 460 U.S. 1001 (1983)	11

STATUTES AND REGULATIONS

47 U.S.C. § 153(29)	36
§ 201(b)	5
§ 202(a)	5
§ 251	13, 15, 40, 41
§§ 251-261	12
§ 252	*passim*
§ 253	12
§ 254	20
§ 271	11
47 C.F.R. § 51.315	41
§ 51.505	18, 26, 32, 34, 38

TABLE OF AUTHORITIES – continued

	Page
47 C.F.R. § 51.507	26
§§ 68.1-68.506	10
4 Colo. Code Regs. § 723-30	11

FEDERAL ADMINISTRATIVE DECISIONS

Carterfone, 13 FCC 2d 420 (1968)	6, 9
Charges for Interstate Tel. Serv., 38 FCC 2d 213 (1972), *aff'd*, 520 F.2d 182 (D.C. Cir. 1975)	6
Coal Rate Guidelines, 1 I.C.C.2d 520 (1985), *aff'd*, 812 F.2d 1444 (3d Cir. 1987)	32
ENFIA Order, 91 FCC 2d 1079 (1982), *recons. granted in part*, 93 FCC 2d 739 (1983)	10
ENFIA Recons. Order, 93 FCC 2d 739 (1983)	10
Joint Cost Order, 2 FCC 2d 1298 (1987)	10
LEC DS3 Serv. Offerings, 4 FCC Rcd. 8634 (1989)	9
Local Competition, 15 FCC Rcd. 3696 (2000)	14, 44
Microwave Communications, Inc., 18 FCC 2d 953 (1969)	6
Open Network Architecture Tariffs, 9 FCC Rcd. 440 (1993)	11, 12
Platform Order, 133 FCC Rcd. 21323 (1998)	20
Private Line Rate Structure Guidelines, 97 FCC 2d 923 (1984)	8, 9
Rates for Dominant Carriers, 5 FCC Rcd. 6786 (1990)	6
SBC Communications Inc., 15 FCC Rcd. 18354 (2000)	15
Second Computer Inquiry, 77 FCC 2d 384 (1980), *aff'd*, 693 F.2d 198 (D.C. Cir. 1982)	10

TABLE OF AUTHORITIES – continued

Page

Universal Serv. Order, 12 FCC Rcd. 8776 (1997), *aff'd in part, rev'd in part*, 183 F.3d 393 (5th Cir. 1999), *cert. denied*, 120 S. Ct. 2212, 2237 (2000) (Nos. 99-1072, 99-1249), *cert. dismissed*, 121 S. Ct. 423 (2000) (No. 99-1244)..... 20

STATE ADMINISTRATIVE DECISIONS

C&P Tel. Co., 70 Md. P.S.C. 341 (Md. P.S.C. 1979)..... 8

Communications Infrastructure Investigation, 1995 WL 553009 (Haw. P.U.C. Aug. 4, 1995) .. 11

Competition in the Local Telecomms. Market, (La. P.S.C. Mar. 15, 1996)..... 11

Implementation of § 13-507 of the Pub. Utils. Act, 162 P.U.R.4th 649 (Ill. C.C. 1995) 11

Long Run Incremental Cost Methodology, 156 P.U.R.4th 1 (Mich. P.S.C. 1994)..... 11

MFS Intelenet, 1995 WL 848272 (Md. P.S.C. Dec. 28, 1995)..... 11

MFS Intelenet, 1995 Pa. PUC LEXIS 87 (Pa. P.U.C. Oct. 4, 1995)..... 12

Open Access to Bottleneck Servs., 1995 Cal. PUC LEXIS 929 (Cal. P.U.C. Dec. 6, 1995) 11

Southern New England Tel. Co., 1995 WL 803837 (Conn. D.P.U.C. Dec. 20, 1995)..... 11

US West Communications, Inc., 165 P.U.R.4th 235 (Utah P.S.C. 1995), *amended*, 1995 WL 798880 (Utah P.S.C. Nov. 27, 1995) 11

Washington Utils. & Transp. Comm'n v. *U S West Communications*, No. UT-950200 (Wash. U.T.C., Apr. 11, 1996) 11

TABLE OF AUTHORITIES – continued

SCHOLARLY AUTHORITIES

Page

P. Areeda & D. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697 (1975)..... 8

W. Baumol & J. Sidak, *Towards Competition In Local Telephony* (1994)..... 31

J. Bonbright et al., *Principles of Public Utility Rates* (1961)..... 31, 38

R. Bork, *The Antitrust Paradox* (1978) 9

S. Breyer, *Regulation and Its Reform* (1982)..... 31

P. Huber et al., *Federal Telecommunications Law* (2d ed. 1999)..... 21

1 A. Kahn, *The Economics of Regulation* (1988).. 30, 38

A. Kahn & W. Shew, *Current Issues in Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191 (1987)..... 29

D. Spulber, *Regulation and Markets* (1989)..... 31

OTHER AUTHORITIES

Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market*, 1997 C(97)3148 21

Industry Analysis Div., Federal Communications Comm'n, *Trends in Telephone Service* (Dec. 2000)..... 3

J. Siegel & J. Shim, *Dictionary of Accounting Terms* (2d ed. 1995) 31

OPINION BELOW

The opinion of the Eighth Circuit is reported at 219 F.3d 744 and is reprinted at 1a-38a of the Appendix of AT&T's Petition for Certiorari ("Pet. App."). The Order of the Federal Communications Commission ("FCC") is reported at 11 FCC Rcd. 15,499 and is reprinted, in relevant part, at 264-452 of the Joint Appendix ("JA").

JURISDICTION

The judgment of the Court of Appeals was entered on July 18, 2000. AT&T's petition for certiorari was filed on October 13, 2000, and granted on January 22, 2001. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The relevant provisions of 47 U.S.C. §§ 153 and 251-252 are reprinted at JA 9 and 11-28.

STATEMENT OF THE CASE

In the 1996 amendments to the Communications Act, Congress sought to promote the rapid introduction of competition in local telephone markets that had long been intractable monopolies. Congress recognized that competitive local carriers could potentially supply some or all of the elements of local telephone service required to reach different classes of customers and that the authorization of local competition could institute a process that would drive retail prices closer to competitive levels.

At the same time, Congress understood that competitive local services cannot and will not develop unless new entrants have the rights economically to access and use those other components of local telephone service that have natural monopoly characteristics and that are controlled by the

incumbent local exchange carriers ("LECs"). Congress thus granted new entrants the rights to "interconnect" with the networks of the incumbent LECs and to "access" designated "elements" of their networks on rates and terms that are "just, reasonable, and nondiscriminatory" and "based on the cost . . . of providing the interconnection or network element." As this Court has held, the Act gives the FCC broad discretion to implement these ambiguous terms in ways that will foster competition. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999).

But following this Court's reversal of its earlier decision, the Eighth Circuit has again invalidated two of the FCC's 1996 regulations in the decision under review. Each regulation was based on the prior experience of the FCC and other tribunals in introducing competition in long distance services, telephone sets, and other former monopoly telecommunications markets.

First, to implement the requirement that interconnection and network element rates be "based on the cost . . . of providing" them, the FCC adopted a forward-looking long run incremental cost method that is called "TELRIC." It provides for full recovery of all of the LECs' costs (fixed and variable) of providing the required facilities by determining the cost of replacing them with the most efficient generally available equipment. This is the same cost of service standard that economists, antitrust courts, state and federal regulatory bodies, and others have long used to determine the "real" and "economic" cost of providing goods or services. It is the standard that incumbent LECs had also themselves successfully advocated and used in indistinguishable contexts both before and after the 1996 Act was passed.

However, while the Eighth Circuit held that the Act authorizes the use of a forward-looking incremental cost standard, the court invalidated the FCC's TELRIC regulation. It concluded that by requiring that rates be based on the cost of providing "*the*" interconnection or network element,

Congress unambiguously barred the use of an efficient replacement cost method. As explained below, the Eighth Circuit's holding has no basis in the statute's terms, structure, and purposes.

Second, the FCC adopted a regulation that requires incumbent LECs to provide new combinations of network elements in circumstances in which it would be discriminatory, unreasonable, and wasteful to require new entrants to do the combining. The Eighth Circuit invalidated this regulation on the ground that the "plain meaning" of the Act is that LECs cannot be required to combine elements in these or any other conditions. But this Court rejected this very claim in *Iowa Utilities Board*.

To place the issues raised by these rulings in context requires a description of (1) local telephone networks and their natural monopoly and other characteristics; (2) the historic monopoly-era regulation of LECs; (3) the regulations that were adopted to develop competition in long distance and other services prior to the 1996 Act; and (4) the 1996 Act and the ensuing FCC rulemaking and other proceedings.

1. Local Telephone Service And Its Natural Monopoly And Other Characteristics.

Historically, telephone service has been provided by franchised incumbent LECs. Each had been granted a monopoly to establish a local telephone network and to offer local and other services in its territories. The principal incumbent LECs are the Bell Operating Companies ("BOCs"), which were part of the integrated Bell System before their divestiture from AT&T in 1984. Today, as a result of mergers, four BOCs (Verizon, SBC, Qwest and BellSouth) and their affiliates now own the telephone lines that serve more than 90% of local telephone customers in the country.[1]

---

[1] Industry Analysis Div., Federal Communications Comm'n, *Trends in Telephone Service* 8-5 (Dec. 2000).

Local telephone service requires a vast array of facilities, systems, and capabilities. But at its most basic level, each incumbent's local telephone network consists of wires (called "local loops") that run from the telephones located in each home or business to a serving "wire center." That wire center contains a local "end office" switch which routes each call and which is connected by wires called "trunk" or "transport" facilities to the wire centers that serve other subscribers. The local networks of all incumbent LECs are interconnected either directly or through intercity ("long distance") transmission facilities -- such that any individual telephone subscriber can place or receive calls from any other subscriber.

Two characteristics of local telephone networks are particularly pertinent. First, they are dynamic. New facilities are constantly being constructed both to meet increased demand for telecommunications services (which has consistently grown at a faster rate than the economy as a whole) and to take advantage of technological innovations that allow basic services to be provided more efficiently and new services to be introduced. For these reasons, the incumbent LECs' networks contain a mixture both of facilities that reflect the latest generally available technologies and of older facilities that are approaching obsolescence. In recognition of this fact, the LECs, for financial accounting purposes, had (in 1996) written off over $23 billion of their net book investments in network facilities. Cox Reply Comments at 27 (May 30, 1996) (JA 171-72).

Second, most local network facilities enjoy substantial economies of scale. Order, ¶ 11 (JA 270-71). Indeed, certain facilities of local telephone networks have significant "natural monopoly" characteristics. For example, no firm today could economically replicate the network of wired local loops used

to serve residential and smaller business customers. *Id.* ¶¶ 10, 378 (JA 269-70, 308-09).[2]

2. The Monopoly Era Regulation Of LECs' Local And Long Distance Services.

For the past century, incumbent LECs have operated under regulatory statutes that required that their rates and practices be "just and reasonable" and "nondiscriminatory." *E.g.*, 47 U.S.C. §§ 201(b), 202(a). State commissions historically exercised jurisdiction over the LECs' calls that begin and end in the same state, and the FCC had this same authority over their rates for "interstate services." *Louisiana Pub. Serv. Comm'n* v. *FCC*, 476 U.S. 355, 360 (1986).

Prior to the late 1960's, the FCC and states engaged in no or very little cost of service regulation of the LECs' rates for individual services and facilities. Incumbent LECs then had monopolies over all the local and long distance telecommunications services and all the basic telephone sets and other "customer premises equipment" used in their service areas. Thus, while regulatory commissions required that rates for basic residential service be affordable, they otherwise generally exercised ratemaking authority only to establish the maximum levels of overall revenues and earnings that LECs' could realize from all their regulated services in aggregate – and to attempt to prevent LECs from earning monopoly profits on their overall operations.

Prior to 1944, this Court's constitutional law holdings had mandated that regulators exercise this authority based largely or entirely on the current cost of replacing the LECs' network. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602-05 (1944). Thereafter, there was a period of years in which the FCC and many state commissions sought to

---

[2] Thus, the only alternative facilities that have anywhere been deployed to serve these customers use radio or existing cable television facilities. These technologies are many years away from being generally deployed.

regulate the LECs' earnings based on the "historic cost" of either the LECs' "prudent investment" or the prudent investment that was "used and useful." See, *e.g.*, *Charges for Interstate Tel. Serv.*, 38 FCC 2d 213, 226 (¶ 40) (1972). However, this system could not be administered in ways that promoted efficiency, and by 1990, the FCC and virtually all state commissions had abandoned their efforts to regulate the overall earnings of LECs. Instead, they adopted systems of "price caps" in which LECs aggregate rates were reduced each year to reflect increases in industry productivity. See *Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6792 (¶¶ 42-43) (1990).

3. The Regulations Adopted To Allow Competition In Long Distance And Other Telephone Services.

In the late 1960s, the FCC authorized new entrants to provide interstate long distance services and customer premises equipment in competition with the incumbent LECs.[3] These orders led to major changes in the regulation of LECs. Instead of regulating only the LECs' overall revenues or earnings, the FCC and state authorities adopted rules designed to assure that LECs provided individual services and facilities under rates, terms, and conditions that were nondiscriminatory and that would allow the authorized competition to develop where technologically and economically feasible. In addition, the LECs' conduct raised parallel issues under the antitrust laws.

The fundamental problem was that while there were components of long distance and the other authorized services that could be provided competitively, competition could not develop unless new entrants and their customers could economically interconnect with and use the local facilities that the LECs controlled. For example, even if a new entrant

[3] *See, e.g.*, *Microwave Communications, Inc.*, 18 FCC 2d 953 (1969); *Carterfone*, 13 FCC 2d 420 (1968).

constructed or leased an alternative long distance network, it could not provide retail long distance services unless it could use the LECs' local loops and other facilities to carry calls between its long distance network and its customers' premises. But where the incumbent LECs would be in competition with the new entrants, the LECs had both the incentive and the ability to discriminate against their competitors in pricing and providing access to these "bottleneck" local facilities that were essential "inputs" into their and their competitors' services.

There were a myriad of ever-changing ways in which LECs could, and did, use their control over essential facilities to prevent and delay competition with their services. But they all involved variations on classic "price-cost" squeezes in which LECs (1) charged retail prices that were at (or below) the costs that the LECs incurred in using their local facilities and providing the other components of the service and (2) prevented competitors from meeting these retail prices by actually (or effectively) charging them excessive rates for the use of local facilities that the LECs provided to themselves at their economic costs.

First, incumbent LECs could, and did, price the retail services that faced competition at competitive levels. At the urgings of the incumbent LECs, antitrust courts, and ultimately regulatory authorities, uniformly rejected claims that incumbent LECs had to price their retail services based on their historic costs, which are "sunk" and "unavoidable" and reflect the costs of inefficient facilities that no carrier would today choose to use to provide services. Some antitrust courts held the LEC prices would be lawful so long as they covered the "short run" variable or "incremental" costs that LECs incurred in providing additional units of service at issue. Those costs are very low in the

telecommunications industry because in the short run most costs of service are "fixed" and few are variable.[4]

And all courts and ultimately the FCC (and state regulators) held that retail prices would be lawful so long as they exceeded the costs determined under a particular "long run incremental cost" method that the Bell System had developed to determine the costs of its one long distance service (called "private line") that initially faced competition.[5] This method determined what it would cost efficiently to reconstruct and operate all of the additional facilities that must be in place for the Bell System to provide all its retail private line services. It thus measured all of the capital and operational costs of the total service – based on the most efficient available technologies and the existing demand for the service – and calculated the "average" of these forward-looking costs. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1115-16, 1124-25 (7th Cir. 1983). This method is often now referred to as "total service long-run incremental cost" or "TSLRIC." Order, ¶ 630 (JA 333).

Notably, while LECs were free to set their retail prices at these long run incremental costs, their local monopolies also gave them the ability and the incentive to engage in predatory pricing and to set retail prices below these levels – without incurring any losses in the short term. In particular, they could subsidize the below-cost portion of the retail rate with inflated prices for monopoly access or other services (which

---

[4] *E.g.*, *Northeastern Tel. Co.* v. *AT&T*, 651 F.2d 76, 87 (2d Cir. 1981); *see also Barry Wright Corp.* v. *ITT Grinnell Corp.*, 724 F.2d 227, 232-33 (1st Cir. 1983) (Breyer, J.); P. Areeda & D. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697, 712 (1975).

[5] *See, e.g.*, *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1123 (7th Cir. 1983); *Private Line Rate Structure Guidelines*, 97 FCC 2d 923, 945-46 (¶¶ 36-37) (1984); *C&P Tel. Co.*, 70 Md. P.S.C. 341 (Md. P.S.C. 1979).

they would justify by misallocating competitive costs to the monopoly services).[6]

Second, whether or not their retail rates covered their incremental costs, the incumbent LECs could – and did – engage in conduct that precluded new entrants from meeting or beating the retail long distance and other prices that the incumbent LECs charged.

Indeed, incumbent LECs engaged in a vast array of conduct that assured that their long distance and CPE competitors incurred dramatically higher costs in using the LECs' essential facilities than the LECs themselves incurred – which erected classic economic barriers to entry. R. Bork, *The Antitrust Paradox* 144-60, 329 (1978). The LECs' conduct included (1) charging their competitors excessive prices for the same facilities and features that the LEC used at cost; (2) forcing competitors to pay charges for items that were not used by LECs or their customers, (3) providing access to competitors that was inferior to that which the LEC enjoyed, and (4) artificially raising rivals' costs by refusing to make feasible changes to their networks that would allow rivals to offer new services. See *United States* v. *AT&T*, 524 F. Supp. 1336 (D.D.C. 1981). Because of the complexity of the local networks, it took massive decade-long proceedings, draconian regulations, and ultimately the restructuring of the telecommunications industry to address this discrimination.

For example, the FCC initially sought to introduce competition into the provision of telephone sets and other customer premises equipment merely by invalidating LEC prohibitions against interconnection of other firms' equipment. See *Carterfone*, 13 FCC 2d 420 (1968). The LECs responded by imposing complicated requirements that they justified on technical grounds – found to be shams years

---

[6] *See, e.g.*, *LEC DS3 Serv. Offerings*, 4 FCC Rcd. 8634, 8339-40 (¶¶ 47, 50) (1989); *Private Line Rate Structure Guidelines*, 97 FCC 2d at 946-47 (¶ 37).

later[7] – that made it more expensive to interconnect competitors' equipment to the local network than to use LEC-provided equipment. Over the next two decades, the FCC responded to these and other forms of anticompetitive conduct by adopting increasingly more detailed technical regulations, separate subsidiary requirements, and non-structural safeguards designed to minimize the risks of discrimination, cost misallocations, and cross-subsidization. See, *e.g.*, 47 C.F.R. §§ 68.1-68.506; *Second Computer Inquiry*, 77 FCC 2d 384 (1980); *Joint Cost Order*, 2 FCC Rcd 1298, 1299-1300 (¶¶ 2-6) (1987).

The problems presented by the introduction of long distance competition proved far more intractable. For example, the FCC was unable to assure that the prices that the BOCs charged for their monopoly access services were nondiscriminatory and represented the economic costs that the BOCs incurred in using these same facilities in their retail interstate long distance services.[8] Indeed, the costing and cost allocation issues were largely outside the ability of the FCC even to address because of the then-existing division of regulatory responsibility over the BOCs' local facilities and the then-existing limitations on the services that competitors could offer.

For these and other reasons, the United States filed an antitrust suit against the Bell System. It sought and obtained (through a consent decree) an injunction that (1) required that the Bell System be split between its local operations (assigned to the BOCs) and its long distance operations (assigned to AT&T) and (2) barred the BOCs from providing interstate or intrastate long distance service for so long as they had local

---

[7] *Litton Sys., Inc.* v. *AT&T*, 700 F.2d 785, 794-802 (2d Cir. 1983).

[8] *See, e.g.*, *MCI Telecomm. Corp.* v. *FCC*, 712 F.2d 517 (D.C. Cir. 1983); *ENFIA Order*, 91 FCC 2d 1079 (1982); *ENFIA Recons. Order*, 93 FCC 2d 739 (1983).

monopolies.[9] The decree thus ultimately assured that all long distance competitors received the same quality of access to essential LEC facilities at precisely the same costs. After this decree was implemented, intense long distance competition developed, leading to extraordinary price reductions and other consumer benefits.

Between 1984 and 1996, there were a variety of contexts in which competition was authorized in local toll and other services that depended on access to the LECs' monopoly facilities. Here, too, incumbent LECs urged, and regulatory bodies adopted, some form of long run incremental cost method to set the pricing "floor" for the LECs' retail services.[10] In addition, the FCC and state regulatory authorities established a "ceiling" for the wholesale rates based on TSLRIC or an indistinguishable method – sometimes with a markup that represented a reasonable allocation of the LECs' overhead and other "joint and common" costs.[11] As the FCC stated, this method is

---

[9] *United States* v. *AT&T*, 552 F. Supp. 131, 160-70, 186-89 (D.D.C. 1982), *aff'd*, 460 U.S. 1003 (1983). The core of the long distance prohibition on the BOCs is now codified in § 271 of the Communications Act. 47 U.S.C. § 271.

[10] *See, e.g.*, 4 Colo. Code Regs. § 723-30; *Implementation of § 13-507 of the Public Utilities Act*, 162 P.U.R.4th 649 (Ill. C.C. 1995) (adopting Sections 791.80 & 791.90); *Competition in the Local Telecomms. Market*, slip op. at 30 (La. P.S.C. Mar. 15, 1996); *US WEST Communications, Inc.*, 165 P.U.R.4th 235, 288, 296 (Utah P.S.C. 1995), *amended*, 1995 WL 798880 (Utah P.S.C. Nov. 27, 1995); *Washington Utils. & Transp. Comm'n* v. *US West Communications*, Docket No. UT-950200, slip op. at 81-87 (Wash. U.T.C. Apr. 11, 1996); *see also* cases cited in *supra*, n. 11.

[11] *See, e.g., Open Network Architecture Tariffs*, 9 FCC Rcd. 440 (1993); *Open Access to Bottleneck Servs.*, 1995 Cal. PUC LEXIS 929, at *1-*3, *68, *94-*99 & App. A (Cal. P.U.C. Dec. 6, 1995); *Southern New England Tel. Co.*, 1995 WL 803837, at *8-*10, *65 (Conn. D.P.U.C. Dec. 20, 1995); *Communications Infrastructure Investigation*, 1995 WL 553009, at *1 (Haw. P.U.C. Aug. 14, 1995); *MFS Intelenet*, 1995 WL 848272 (Md. P.S.C. Dec. 28, 1995); *Long Run Incremental Costs*

"forward-looking" and based on the efficient "replacement costs" of the BOCs' facilities: that is, the "inputs [the BOC] would purchase today at the price it would have to pay to purchase those inputs today." *Open Network Architecture Tariffs*, 9 FCC Rcd. 440, 449-50, 454 (¶¶ 21, 36) (1993).

In addition, during this period, two different BOCs made filings with foreign regulators that argued that the incumbent monopolists in those countries should be required to grant access to new entrants at the long run incremental cost (LRIC) of providing the interconnections. They emphasized (1) that "because LRIC is forward-looking, competitors [would not be] paying for inefficiencies in an operator's network" and (2) there are now available computer "models" which will allow a "bottom up" determination of the "actual costs" of establishing and operating an efficient local network.[12]

4. The 1996 Act And The Ensuing Proceedings.

In the Telecommunications Act of 1996, Congress sought to open local markets to the possibility of the kind of competition that existed in long distance services. Congress enacted a new subchapter of the Communications Act that was designed rapidly to introduce whatever forms of local competition are now economically and technologically feasible. 47 U.S.C. §§ 251-261. It expressly preempts the state laws that had previously prohibited competitive local services. *Id.* § 253. But just as abolishing the Bell System's

---

Methodology, 156 P.U.R.4th 1, 4-17 (Mich P.U.C. 1994); *MFS Intelenet*, 1995 Pa. PUC LEXIS 87, at *67 (Pa. P.U.C. Oct. 4, 1995). *See also* Order, ¶ 631 (JA 334-36) (discussing use of LRIC methodology by state commissions prior to 1996 Act).

[12] U S West International, A Framework For Effective Competition: Response To OFTEL's Consultative Document, at 12 (Mar. 30, 1995); *accord*, Comments of BellSouth Europe To The European Commission's Green Paper On The Liberalisation of Telecommunications Infrastructure (Mar. 15, 1995).

long distance monopoly could not itself create long distance competition, Congress recognized that broad-based entry in the entire local exchange market could not develop without both (1) the two entry vehicles that are at issue here and (2) the FCC rules that implement these provisions and that will govern the negotiation and state arbitration of specific interconnection agreements between LECs and new entrants.[13]

The Interconnection And Access Requirements. First, Congress understood that even when it is economically and technically feasible to construct complete alternative local telephone networks, local competition would not develop unless the incumbent LECs have affirmative duties to share their networks with competitors at economic costs. That is so because an essential feature of telephone service is that customers have the ability to place, and receive, calls from all other telephone subscribers. But a new entrant cannot offer this capability to customers unless the incumbent LEC "interconnects" with the network of a new entrant and allows the new entrant to use the incumbent's facilities to complete the calls that its customers place to the incumbent's subscribers. Section 251(c)(2) thus requires each incumbent LEC to "interconnect" with any requesting carrier at rates and on terms and conditions that are "just, reasonable, and nondiscriminatory" and that satisfy the requirement of § 252(d)(1) that rates be "based on the cost . . . of providing the interconnection or network element." 47 U.S.C. §§ 251(c)(2), 252(a)(1); see also *id.* §§ 251(b)(5), 252(d)(2) (requiring all competitive and incumbent LECs to transport and terminate calls at cost).

---

[13] Congress also authorized a third method of entry – resale of retail telecommunications services – but it does not permit new entrants to provide the "exchange access" services required to serve the entire local services market. *See* 47 U.S.C. § 251(c)(4).

Second, because of the economies of scale and other economic characteristics of some local telephone facilities, Congress understood that it generally is not economic for competing firms to establish all of the facilities required to provide competing services. To be sure, there are retail functions and particular network facilities that can be provided efficiently by new entrants – as confirmed by the FCC Order on remand from *AT&T Corp.* v. *Iowa Utilities Board*.[14] But broad-based competition cannot develop unless new entrants also have the right economically to lease other facilities and functions from incumbents and to incorporate them into the separate networks that the new entrants establish. Order, ¶¶ 10-12 (JA 269-72).

For example, AT&T's strategy has been initially to serve most business customers by leasing unbundled local loops and transport facilities from LECs and by integrating them with AT&T's switching and other facilities. Similarly, in the many areas where AT&T owns no cable television systems or has not upgraded them to provide telephony, AT&T's strategy has been to lease existing, or new, combinations of loops, switching and transport from the incumbent and integrate them with AT&T's operator systems, directory assistance systems, and retail and customer care systems. AT&T has adopted these strategies even though the arrangements inherently impose enormous transaction and other costs on AT&T that incumbents do not bear.[15] The

[14] *See Local Competition*, 15 FCC Rcd. 3696 (1999) (determining that competitors now will not be "impair[ed]" without access to certain of the network facilities that had been designated as network elements in 1996).

[15] For example, when AT&T and other new entrants lease an unbundled local loop from the incumbent and combine it with an AT&T switch, the incumbent LEC has been deemed to satisfy the duty to provide unbundled elements on terms that are "just, reasonable and nondiscriminatory" if it causes substantial outages for "only" 5% of AT&T's customers. That is so even though LEC customers run no remotely comparable risk of service outages. *See SBC Communications*, 15 FCC Rcd. 18354, 18442-43 (¶ 177) (2000).

reason is that all the alternative means of entering local markets would require AT&T to incur radically higher costs and place it at far greater disadvantages relative to the incumbents.

In recognition of this fact, Congress gave new entrants the right to access and use the incumbent LEC facilities and functions on the same terms and at the same economic costs as does the LEC itself. In § 251(c)(3) of the Act, Congress provided that any requesting carrier can (1) access network elements on rates, terms, and conditions that are "just, reasonable, and nondiscriminatory" (47 U.S.C. § 251(c)(3)) and "based on the cost . . . of providing the . . . network element" (*id.* § 252(d)(1)(A)) and (2) "use" the element to provide any telecommunications services.

FCC Rulemaking Proceeding. In the FCC's rulemaking proceeding, it extensively dealt with the rules required to implement the single standard that § 252(d)(1) adopts to govern the setting of "just and reasonable" rates for both interconnection and network elements: that rates "shall be . . . based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)" and "non-discriminatory." *Id.* § 252(d)(1).

In its Notice of Proposed Rulemaking, the FCC proposed that interconnection and network element rates be set under the Total Services Long Run Incremental Cost ("TSLRIC") method (see *supra* p. 8), and the FCC sought comment on this and other methods. The Antitrust Division and new entrants – supported by the testimony of distinguished economists – urged the adoption of TSLRIC. Order, ¶ 635 (JA 340-42).

For example, AT&T submitted detailed affidavits of Professors William Baumol, Janusz Ordover, and Robert

Willig, who explained that TSLRIC would measure the total forward-looking costs (including risk-adjusted capital costs) of providing the entire outputs of each of the network elements and interconnection arrangement that are authorized. They stated that TSLRIC represents both the prices that would be charged for such elements if they were provided competitively and the economic costs that the incumbent LECs would themselves incur in using the elements to provide their competing retail services.[16]

By contrast, most (but not all) of the incumbent LECs urged the adoption of a "historic cost" standard in which rates would be based on the costs that LECs incurred in the past and that are recorded in the LECs' ratemaking "books of account." Order, ¶ 638 (JA 344-46). LECs did not advance this position on grounds of economic efficiency or of rational competitive policy. Rather, they maintained that they had a right (under an alleged implicit "regulatory compact") to recover their historic cost and that adoption of a historic cost standard to establish network element rates would assure that these costs are recovered and not "stranded." However, the LECs' economists all emphasized that long run incremental cost was the proper starting point and the method that would foster economic efficiency – so long as the method included a markup for the LECs' "joint and common costs" and that the depreciation and return on investment component of the rates reflected all the risks that LECs faced.[17]

---

[16] AT&T Comments (May 16, 1996), William Baumol, Janusz Ordover, and Robert Willig Aff. at 2-15 (JA 59-75); AT&T Reply Comments (May 30, 1996), William Baumol, Janusz Ordover, and Robert Willig Reply Aff. at 2-3, 7 (JA 141-48).

[17] *See* Bell Atlantic Comments (May 16, 1996), Robert Crandall Decl. at 6 (JA 84-85); *see also id.*, Jerry Hausman Aff. at 2-3 (JA 89-92); GTE Comments (May 16, 1996), Edward Beauvais Aff. at 2-4, (JA 103-07); US WEST Comments (May 16, 1996), Robert Harris and Dennis Yao Report at 5 (JA 136-38).

For example, Dr. Alfred Kahn suggested that LECs had a constitutional or equitable right to recover their historic book costs to the extent that they "exceed forward-looking costs." But even if they had this right, Dr. Kahn stated that it would be "preferable on grounds of pure economic efficiency if these justified [historic] costs" were not recovered "in the prices of [the network element and interconnections] inputs" purchased by LEC competitors. Rather, they should be recovered in competitively neutral surcharges "in the prices for final products or services only."[18]

LEC economists also criticized the TSLRIC proposals of AT&T and others on the ground that TSLRIC would determine the costs of reengineering LEC facilities on a "blank slate" that ignored all the characteristics of the existing networks. They complained that this "scorched earth" method could require determinations of whether alternative technologies that would use very different facilities and layouts (*e.g.*, wireless systems or cable television) had become the most efficient means of providing service.[19] No LEC economist proposed a method that would determine the costs for providing network elements based on the current prices of replicating the LECs' existing facilities – many of which are approaching obsolescence.

The FCC's Local Competition Order. In the FCC's Order, it adopted the TSLRIC standard, but made several adjustments to it to reflect the concerns that had been raised by the LECs' economists. And because the method was primarily being applied to network elements and not services,

---

[18] Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 8 (JA 160-62).

[19] Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 3-5 (JA 153-57); USTA Reply Comments (May 30, 1996), Jerry Hausman Reply Aff. at 10-11 (JA 200-02); US WEST Reply Comments (May 30, 1996), Robert Harris Reply Aff. at 8-9 (JA 206-09).

the FCC labeled its method Total Element Long Run Incremental Cost or TELRIC. Order, ¶ 678 (JA 378-79).

First, the FCC found that long run incremental costs represent the economic costs that incumbent LECs in fact incur when they provide elements and interconnections to competitive carriers. Order, ¶¶ 679, 685 (JA 379-80, 383-84). The FCC concluded that to the extent that these TELRIC rates would be lower than those set under a historic cost method and residual costs were not recovered, it would be inefficient and anticompetitive to mark up network element and interconnection rates to recover them. The FCC found that any such markup would subject new entrants to price squeezes, would encourage inefficient entry, and would artificially inflate retail rates. It thus concluded that (consistent with Dr. Kahn's testimony) if there were residual unrecovered costs, they should be recovered, if at all, in competitively neutral surcharges or in LEC rates for other services. *Id.* ¶¶ 706-707 (JA 399-401). The FCC's regulation thus expressly barred any consideration of the LECs' "[e]mbedded" historic costs in setting network element and interconnection rates. 47 C.F.R. § 51.505(d)(1).

Second, the FCC addressed the LECs' other concerns. It provided that the TELRIC-based rates should recover all of the total long run forward-looking costs of satisfying the entire demand for the element – plus a reasonable allocation of overhead and other joint and common costs attributable to the provision of the element. Order, ¶¶ 694-698 (JA 388-92). In response to the LECs' concerns, the FCC similarly made it explicit that the depreciation and return on investment components of the rates should reflect the "declines in value of capital goods" due to technological innovations and all the other risks of operating under such a regime. *Id.* ¶¶ 686-687 (JA 384-85).

The FCC next addressed the concerns that the use of a "blank slate" method would be administratively unwieldy and could provide disincentives for the construction of alternative

networks. Rather than basing costs on the "least-cost, most efficient network configuration and technology currently available," it required that rates be set based on "the incumbent LECs' current wire center[s]": that is, that state commissions assume that a new reconstructed network would deploy switches in the same locations that incumbent LECs currently use and that local loops and transport facilities would continue to be terminated at these same locations. The FCC stated that the "reconstructed local network [must otherwise] employ the most efficient technology for reasonably foreseeable capacity requirements." Order, ¶¶ 683-685 (JA 382-84). The FCC did not believe that this qualification would today represent a substantial departure from economic efficiency, for the FCC found that this method "most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants." *Id.* ¶ 685 (JA 384).

Finally, the FCC rejected a method in which the rates would be "based on the existing network design and technology that are currently in operation." Because any such method would set rates based on the LECs' "existing operations" and prices for "inefficient or absolute network design and technology," the FCC found that "[t]his is essentially an embedded cost methodology." Order, ¶ 684 (JA 383).

The Subsequent Independent Adoptions of TELRIC or Its Equivalent. Following the adoption of the FCC's Order, numerous regulatory bodies independently adopted cost standards that were indistinguishable from TELRIC in all respects relevant to this appeal. Indeed, certain of the incumbent LECs themselves advocated this very approach for determining the costs of providing network elements and interconnections.

First, in addition to requiring cost-based interconnection, the 1996 amendments to the Communications Act required the adoption of new competitively neutral methods to

promote universal service: that is, the funding of the below-cost rates that assure that local telephone service is affordable in rural and high cost areas. See 47 U.S.C. § 254. This, too, required the development of a method to determine all the costs of providing local telephone service, including the underlying network elements. To make this determination, a Benchmark Cost Proxy Model was developed by a consortium of carriers that, at different times, included incumbent LECs that are affiliates of each of the four firms that collectively now own over 90% of local telephone lines. Like TELRIC, this model determines the forward-looking costs of providing network elements by reconstructing "all plants . . . at a single point in time using the existing wire centers of incumbents" and the "most efficient available technology and network design."[20] In its subsequent *Universal Service Order*, the FCC adopted this forward-looking methodology,[21] and the Fifth Circuit upheld that policy choice.[22]

Second, after the FCC's local competition rules were adopted, the Eighth Circuit stayed the FCC's pricing rules on the jurisdictional ground that the FCC had no authority to adopt a cost standard that governs arbitration proceedings conducted by state commissions. During the three-year period in which the stay was in effect and before this Court reversed the Eighth Circuit's jurisdictional holding (*AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 730), state regulatory commissions were free to adopt whatever pricing

---

[20] *See Universal Serv. Order*, 12 FCC Rcd. 8776, 8903-16 (¶¶ 232-250) (1997) (describing cost model developed by LECs); *see also Platform Order*, 13 FCC Rcd. 21323, 21364-83 (App. A) (1998).

[21] *Universal Serv. Order*, 12 FCC Rcd. at 8916 (¶ 250).

[22] *See Texas Office of Pub. Util. Counsel* v. *FCC*, 183 F.3d 393 (5th Cir. 1999).

methodology they believed most appropriate. Most adopted TELRIC.[23]

Third, during this same period, the European Commission adopted recommended standards to govern interconnection with incumbent telephone monopolies in its member states. It adopted a method which it labeled "forward-looking long run average incremental cost." The European Commission stated that its method will ultimately require "building 'bottom-up' models whereby an economic/engineering model of an efficient network is developed, from which interconnection costs can be calculated by aggregating the costs of individual network elements," and by including "markups" to recover "the forward looking joint and common costs of an efficient operator." Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market* §§ 3.3, 3.5, 1997 C(97)3148. The European Commission stated that these establish the incumbents' "economic or 'real'" costs of providing interconnection and represent the rates that would be charged in a competitive market. *Id.* § 3.3. This is the cost standard that BellSouth and U S West (now "Qwest") had urged European regulators to adopt. See *supra* p. 12 & n. 12.

5. The Eighth Circuit's Decision On Remand.

In *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. 366 (1999), this Court reversed the Eighth Circuit's 1997 decision that had vacated TELRIC and many of the FCC's other local competition rules. This Court rejected the Eighth Circuit's jurisdictional holding and held that § 201(b) of the Act gives the FCC jurisdiction to adopt rules that "carry out" all the Act's pricing and other local competition provisions. *Id.* at 378. The Court further held that the Eighth Circuit had erred in vacating the FCC rule (51.315(b)) that required incumbent

---

[23] *See* C.A. Docket Entry 1099949-1, Apps. B and C (Mar. 9, 1999); *see also* P. Huber et al., *Federal Telecommunications Law* § 2.4.4.1, at 185 (2d ed. 1999).

LECs, upon request, to provide new entrants with existing combinations of network elements. *Id.* at 394-95. The Court ruled that the FCC has authority to adopt rules that prevent discrimination and that the final sentence of § 251(c)(3) does not bar the FCC from ordering the LECs to provide combinations of elements when that was found to be an appropriate means of preventing discrimination. *Id.* The Court then remanded the case to the Eighth Circuit to address the LECs' substantive challenges to the FCC's pricing rules and to reconsider its other holdings in light of the Court's rulings. *Id.* at 397.

On remand, the Eighth Circuit again invalidated the FCC's TELRIC regulation. Pet. App. 9a. Although it rejected the LECs' claim that the Act required a historic cost method and held that a forward-looking cost method is consistent with the Act's terms and "stated purpose," the court held that the regulation violated the plain terms of the Act insofar as it required that forward-looking determinations be based on the costs of efficiently replacing the LECs' facilities. *Id.* at 7a-8a. While the Eighth Circuit vacated only the subsection of the FCC's rule (51.505(b)(1)) that required that rates be set on this basis, the court remanded the entire rule to the FCC for reconsideration in light of the Eighth Circuit's decision. *Id.* at 14a.

The Eighth Circuit also refused to vacate its earlier decision that invalidated the FCC rule that required the incumbent LECs to effect technically feasible new combinations of network elements when the requesting carrier pays all the costs of the new combinations. Pet. App. 25a (vacating 47 C.F.R. § 51.315(c)-(f)). The Eighth Circuit again held that this rule is inconsistent with the final sentence of § 251(c)(3). *Id.*

SUMMARY OF ARGUMENT

The Eighth Circuit erred in vacating the two FCC regulations at issue. Each regulation is consistent with the

"particular statutory language at issue, as well as the language and design" of the local competition provisions of the Communications Act "as a whole." *Kmart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291-92 (1988). Each further represents an eminently "reasonable" judgment on the "policy choice" that Congress committed to the FCC. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 845 (1984).

1. There is no basis for the Eighth Circuit's holding that the 1996 Act prohibits the FCC from requiring that interconnection and network element rates be based on today's prices for efficiently replacing those facilities and functions. This is the "cost of service" ratemaking standard that this Court formerly required, and now expressly permits, regulatory bodies to use when they are determining the maximum revenues and earnings that a regulated firm can realize from all its regulated services.

Moreover, the object here is to assure that incumbent LECs price individual essential services at levels that will allow efficient competition in the "unshared" aspects of local service by preventing "price squeezes" from foreclosing this competition. Antitrust courts, the FCC, other federal regulatory bodies, state utility commissions and other tribunals have long used replacement cost methods to determine the economic costs of individual services and facilities for this very purpose.

In holding that the terms of § 252(d)(1) bar the use of efficient replacement costs in setting these rates, the Eighth Circuit rested on the ground that § 252(d)(1) requires that the "just and reasonable" rates be based them on the costs of providing "*the* interconnection or network element (whichever is appropriate)." 47 U.S.C. § 252(d)(1) (emphasis added). The Eighth Circuit concluded that the use of the modifier "the" means that the rates must be based on the actual facilities that the new entrant will use, not "hypothetical" facilities that embody the most efficient

available technology. In the Eighth Circuit's view, it followed that TELRIC is invalid.

First, this decision would be erroneous even if the Eighth Circuit had correctly construed the term "the." For the Eighth Circuit was simply wrong in concluding that replacement cost methods do not determine the "costs" that the LECs incur in providing their "actual" existing network facilities today. The FCC expressly found precisely the opposite. Further, the decisions of antitrust courts, state and federal regulatory bodies, and the European Commission have all concluded that TELRIC and other replacement cost methodologies determine the "economic" and "real" costs to a firm of providing its actual facilities today.

Second, even if that were not the case, the Eighth Circuit is also wrong that the Act unambiguously mandates that costs be set on the basis of the "actual facilities" of the "incumbent LEC" that will be providing them. Indeed, in context, the term "the" merely requires that rates be based on the particular type of facility at issue – *e.g.*, an interconnection or a local loop as opposed to another network element. Further, under the Act and the FCC's rules, LECs provide competitors not with actual facilities, but with "features, functions, or capabilities." In short, the Act's terms do not permit, much less compel, a reading in which rates have to be based on the "actual facilities" of any particular LEC.

Finally, the Eighth Circuit's decision would require outcomes that are, at best, far less reasonable than the FCC's approach and, at worst, absurd. Under its decision, forward-looking cost determinations would be required to be made under one of two methods. The first is the "cost of reproducing obsolete technology." Pet. App. 7a. It is a method that would inflate rates far above TELRIC and that Justice Brandeis long ago condemned as the worst of all possible methods. *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment). The second is a short run

incremental cost or other method that is dramatically less favorable to LECs than TELRIC. That the Eighth Circuit would require a choice between two extreme opposing outcomes underscores that TELRIC rests on a reasonable interpretation of the Act to which the Eighth Circuit was required to defer.

2. The Eighth Circuit similarly erred in refusing to reinstate the FCC rules (51.315(c)-(f)) that require incumbent LECs to combine network elements when that is technically feasible and the requesting carrier pays all costs of the combination. The FCC adopted this rule because it found – based on the record and its experience – that a refusal by incumbent LECs to deal on these terms would violate the requirement (of the first sentence of § 251(c)(3)) that they provide access on terms that are "just, reasonable, and nondiscriminatory." The Eighth Circuit did not and could not question this finding. However, it refused to reinstate the rule because it concluded that the next sentence of § 251(c)(3) – which requires the LECs to provide elements "in a manner that allows new entrants to combine them" – bars the FCC from preventing discrimination by ordering LECs to provide combinations of elements. But this Court unanimously rejected this proposed construction of § 251(c)(3) in *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 394-95.

ARGUMENT

I. TELRIC IS A REASONABLE METHOD OF IMPLEMENTING THE MANDATE THAT INTERCONNECTION AND NETWORK ELEMENT RATES BE BASED ON THE COST OF PROVIDING THEM.

The FCC's TELRIC regulation epitomizes the policy determinations that Congress delegated to a federal agency. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844-45 (1984). TELRIC represents the best

practical – and assuredly a reasonable – method of implementing the statutory requirement that rates for interconnections and network elements be "just and reasonable," "based on the cost of providing [them]," and "nondiscriminatory." 47 U.S.C. § 252(d)(1).

Specifically, the TELRIC regulation provides that, in calculating these rates, state commissions cannot "consider" the LECs' retail costs and their historic "embedded costs," which are defined as "the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LECs' books of accounts." 47 C.F.R. § 51.505(d)(1), (2). Instead, the regulation provides that the rates for each type of element should be based on (1) "the most efficient telecommunications technology [that is] currently available, and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers" and (2) the "total quantity of the facilities and functions that are directly attributable" to meeting the total existing demand for that element, "taking as a given the incumbent LEC's provision of other elements." *Id.* § 51.505(b). The rates are to include a "reasonable allocation" of joint and common costs and the LECs' capital costs (risk adjusted return on investment and economic depreciation). *Id.* §§ 51.505(a), (b)(2)-(3).

Under this standard, States are thus to set rates for individual network elements – *e.g.*, the local loop – based on the capital costs that an efficient carrier would incur today if it efficiently reconstructed the facilities that connect telephones in homes and business to the LECs' existing wire centers. Under the FCC's rules, states obviously need not calculate rates on a loop-by-loop or customer-by-customer basis, but establish averaged statewide rates that will vary depending only on the population density of the particular area in which the loop is provided (with the state required to establish rates for a minimum of three levels of density). *Id.* § 51.507(f).

The Eighth Circuit invalidated this regulation on a nominally narrow ground. It rejected the incumbent LECs' claim that this regulation is unlawful because it does not guarantee that LECs will recover all of their embedded "historic" costs in their interconnection and network elements rates. Pet. App. 9a-10a. The Eighth Circuit held that that would be inconsistent with the Act's "stated purpose[]" of promoting competition. *Id.* at 10a. However, the Eighth Circuit vacated the subsection of the rule (51.505(b)(1)) that required that forward-looking determinations be based on the most efficient available technologies, and the Eighth Circuit remanded the entire rule to the FCC for reconsideration. *Id.* at 14a.

The Eighth Circuit rested this holding on the ground that § 252(d)(1) provides that "just and reasonable" rates for interconnections and network elements be based on the "cost of providing *the* interconnection or network element (whichever is applicable)." Pet. App. 6a; JA 22-23. The Eighth Circuit concluded that the statute's use of the definite article "the" in this context meant that Congress has "directly addressed" the precise question at issue (*Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984)) and mandated that interconnection and network element rates be based on the LECs' "actual facilities," not on a "hypothetical" and "fantasy" network that does not now exist. In the Eighth Circuit's view, it followed that the TELRIC regulation is invalid. Pet. App. 7a-8a.

This holding is plainly wrong. *First*, even if the Eighth Circuit's construction of the Act were correct, it would not support its invalidation of the regulation. The FCC here found, as decades of prior decisions establish, that TELRIC and other efficient replacement cost methodologies determine a LEC's costs of providing its "actual" services and facilities. *Second*, the Eighth Circuit's interpretation of the statutory text is not a remotely plausible one, much less the only possible one, and the Act is reasonably read to permit

determinations of the cost that any firm would incur today in replacing and operating the LEC facilities in question. *Third*, the Eighth Circuit's decision would produce the absurdity that interconnection and network element rates would be required to be set under either uniformly condemned standards that would inflate rates far above TELRIC or other standards that would be far less favorable to LECs than TELRIC.

A. TELRIC Determines The Costs Of Providing The LECs' "Actual Facilities."

Although the Eighth Circuit's decision rests on a misinterpretation of the Act's "plain meaning," the FCC's TELRIC regulation would be valid even if the Eighth Circuit were correct that § 252(d)(1) requires rates to be set based on the LECs' costs of providing their "actual" facilities. The FCC repeatedly found that TELRIC determines the "economic costs" of the incumbent LECs in providing their facilities. Order, ¶¶ 675, 679 (JA 377, 379-80). It found that "[i]ncremental costs are the additional costs . . . that a firm will incur . . . by producing an additional quantity of the good or service." *Id.* ¶ 675 (JA 376-77). It found that TELRIC will result in prices that "most closely represent[] the incremental costs that incumbents actually expect to incur in making network elements available to new entrants," and that it "should facilitate competition on a reasonable and efficient basis" by allowing new entrants to use essential facilities "based on costs similar to those incurred by the incumbents" who will, of course, use these same actual facilities. *Id.* ¶¶ 679, 685 (JA 380, 384). TELRIC simply was not intended to do anything other than measure a LEC's costs of providing its "actual facilities."

Further, even if the FCC had not expressly so found, it is well settled that replacement cost methodologies measure the costs that firms incur in providing their "actual" goods or services. Indeed, the 1996 amendments to the Communications Act were enacted against the background of literally decades of decisions that so concluded. Ironically,

these are same decisions and principles that required the Eighth Circuit's correct holding that the Act does not mandate a "historic cost" methodology.

First, as the Eighth Circuit noted, the term "cost" has no single meaning. It is a "chameleon, capable of taking on different meanings" in different contexts. *Strickland* v. *Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995). Similarly, this Court has held that "cost" is a term that "connotes the use of judgment and has no technical meaning." *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983).

In addition, as the Eighth Circuit implicitly recognized, here the context is quite specific. Section 252(d)(1) does not direct a determination of the "cost" of "the" network element or interconnection. The determination that is required is of the "cost . . . of *providing* the interconnection or [the] network element." 47 U.S.C. § 252(d)(1)(A) (emphasis added). So even if the modifier "the" requires a focus on the LECs' "actual facility," the question is not what is the cost of the facility. The question is what is the cost of "providing" it.

Second, as the Eighth Circuit also noted, the costs of "providing" the incumbent LECs' "actual facilities" need not – and in this context should not – be based on the amount of the LECs' historic investments in the facilities. There is "no truism in economics more elementary" than that these historic costs "are to be ignored" in determining the economic costs incurred in providing a firm's actual goods and services. A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987). The past investments are "sunk" and "unavoidable," and the economic measure of the costs are the incremental "current" or "future" operating and capital costs that the firm incurs as a result of offering its goods and services now and in the future. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-17 (7th Cir. 1983).

Third, the costs that are considered incremental will vary depending on the size and timing of the increment. 1 A. Kahn, *Economics of Regulation* 70-71 (2d ed. 1988). The law measures incremental costs in one of two different ways. "Short run" incremental cost methods reflect the fact that the firm has sunk fixed investments that will not be immediately replaced, that will often be less cost-effective than currently available alternatives, and that will require that the firm meet current demand through incremental investments and expenditures that firms with newer plants would not make. A short run incremental cost method assigns no costs to the sunk fixed investments and calculates only the incremental operating expenses and capital costs that will result from meeting current or future demand in the short run. *Northeastern Tel. Co.* v. *AT&T*, 651 F.2d 76, 86 (2d Cir. 1981). It is a particularly appropriate method when the sunk investments will never be replaced. 1 Kahn, *supra*, 72-73.

By contrast, a "long run" incremental cost method selects a period of time that is long enough for all costs to be variable. This method determines all the fixed and variable operating and capital costs of providing a facility or service in a competitive market. In competitive markets, prices will tend toward long run incremental cost, for if a firm with less efficient facilities charged higher prices, it would immediately be undercut by a new entrant that used the most efficient available assets. *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-17 (7th Cir. 1983); 1 Kahn, *supra*, 67.

By determining the cost of efficiently replacing the facilities of an incumbent firm, long run incremental cost methods make cost determinations based on the value of the incumbent's actual existing facilities. For example, if a firm purchased a computer three years ago for $1000 and an equivalent computer can be purchased today for $500, the value of the firm's investment in the computer today is $500. The cost to the firm of using its "actual computer" in providing its services is thus no more than the sum of the

operating expenses and the capital costs (*i.e.*, economic depreciation and return on investment) of the $500 computer that is available in the market today. See W. Baumol & J. Sidak, *Towards Competition In Local Telephony* 60 (1994). "A competitive marketplace values assets, not at their historical price, but at their *replacement* value – the present cost of obtaining the identical service that the old asset provides." S. Breyer, *Regulation and Its Reform* 38 (1982).

For these reasons, the law could not be clearer that replacement cost is a measure of the cost of a firm's actual goods or services and that a rate set on this basis is "just and reasonable" and "based on the cost" of providing the firm's actual goods or services. In particular, replacement cost has long been one of the two basic recognized methods of cost of service ratemaking. J. Bonbright et al., *Principles of Public Utility Rates* 119 (2d ed. 1988). It is also the measure favored by economists. See D. Spulber, *Regulation and Markets* 276 (1989).

Indeed, this Court formerly required state and federal commissions to regulate a firm's maximum overall revenues under "replacement" or "reproduction" cost standards. See *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308-09 (1989). While these terms were "variously defined," the most "useful" and only economically sound definition was "the minimum amount [of investment] necessary to create at the time of the inquiry a modern plant capable of rendering equivalent service." *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 622 n.3 (1944) (Reed, J., dissenting).[24] In Justice Breyer's words, that method "bear[s] an uncanny resemblance to TELRIC." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part). While the requirement to set rates under this standard ended in 1944,

---

[24] *See* J. Siegel & J. Shim, *Dictionary of Accounting Terms* 343 (2d ed. 1995) (defining replacement cost as the "current cost to replace the service potential of an existing asset").

this Court has since held that replacement cost continues to be a permissible method of determining a utility's cost of service, and of setting "just and reasonable" rates. *Mobil Oil Exploration & Producing Southeast Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224-25 (1991); see *Duquesne Light Co.* v. *Barasch*, 488 U.S. at 308-09.

Similarly, replacement cost is the cost of service method that the Interstate Commerce Commission and later the Surface Transportation Board adopted to set the "reasonable" rate that a railroad can charge captive shippers under the 1980 amendments to the Interstate Commerce Act. See, *e.g.*, *Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 (1985). In particular, these agencies use a method which calculates the investments and expenditures that a railroad would make if it replaced all the facilities required to provide only the transportation services used by that shipper. Courts have upheld this standard because it is a reasonable determination of the costs that a railroad incurs in serving these shippers. See, *e.g.*, *Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444, 1453-57 (3rd Cir. 1987); *Potomac Elec. Power Co.* v. *ICC*, 744 F.2d 185, 194-95 (D.C. Cir. 1984). TELRIC is expressly based on this method.[25]

Even more fundamentally, in contrast to the provisions at issue in the foregoing cases, the object of § 251 is to assure that incumbent LECs cannot use their control over essential facilities to effect price-cost squeezes that prevent competition with their retail services. Order, ¶ 679 (JA 379-80). And, as explained in detail above, the 1996 Act was enacted against the background of antitrust, state, regulatory

---

[25] Indeed, the ICC/STB method differs from TELRIC only because it effectively allocates all overhead and "joint and common" cost to the service, thus establishing the "stand-alone cost" of providing only a single service. Notably, while TELRIC provides for only a "reasonable" allocation of "joint and common costs," it provides that "stand alone cost" is the maximum rate that can be charged for any network element. 47 C.F.R. § 51.505(c)(2)(i).

and FCC decisions that had adopted efficient replacement cost methods to determine the costs, and lawful prices, of individual services of LECs and other incumbent firms for this very purpose. See *supra* pp. 6-12.

The point is also confirmed by decisions since the 1996 Act was passed. For example, as noted above, during the period in which the FCC's pricing rules were stayed on jurisdictional grounds, state commissions were free to use any cost of service ratemaking method and most independently adopted TELRIC or a similar efficient replacement cost standard. See *supra* pp. 20-21. Incumbent LECs had themselves urged European regulators to set interconnection rates under this cost standard, and the European Commission recently agreed. It concluded that the "real" and "economic" costs that incumbent telephone carriers incur in providing interconnections to its existing network should based on the costs of a "bottoms up" reconstruction of the facilities with the most efficient generally available technology. See *supra* p. 21.

Finally, it is ironic that the Eighth Circuit would assert that TELRIC is unlawful because it is "hypothetical" and putatively rests on "fantasy." As Drs. Baumol, Willig, and Ordover explained below, all ratemaking methods rest on "hypothetical constructs," but TELRIC does so to a far lesser extent than the other methods that were proposed. Baumol et al. Reply Aff. at 6 n.4 (JA 147). It rests on the "actual prices" that LECs actually pay today for generally available equipment that is more efficient than their older existing facilities. *Id.* at 7 n.5 (JA 147). This determines the value of the "actual facilities" that the BOCs are providing. The "fantasy" would be to ignore these actual costs.

Indeed, the Eighth Circuit's suggestion is peculiarly misplaced for another reason. The FCC addressed the LEC's stated concerns about the hypothetical nature of this methodology by directing that the determinations be based on the incumbent LECs' existing wire center locations. Order,

¶¶ 682-685 (JA 381-84); 47 C.F.R. § 51.505(b)(1). This fully responded to the LECs' concern that regulatory bodies could be required to assess whether wireless or cable television based services were more efficient than the existing LEC networks, and it represented a "pragmatic adjustment[]" that was uniquely committed to the FCC's discretion. *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 329 (1974); *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

In short, TELRIC determines the costs of providing the "actual" interconnection and network elements that LECs provide to requesting carriers. Thus, the regulation would be valid even if the Eighth Circuit had correctly construed § 252(d)(1).

B. The Eighth Circuit Misconstrued § 251(d)(1).

However, the Eighth Circuit's construction of § 252(d)(1) is wrong for two reasons. First, by using the word "the" to modify "interconnection" and "network element," Congress has not "directly spoken" to the issues and unambiguously required that ratemaking determinations consider only the "actual facilities" that the LEC will provide. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). Second, even if the modifier "the" had the significance that the Eighth Circuit gives it, the other terms of the Act foreclose any claim that the ratemaking inquiry must be directed at the costs of providing the LECs' "actual facilities."

1. Section 252(d)(1) provides as follows:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) and section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section 251(A) shall be (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing *the* interconnection

> or network element (whichever is applicable), and (ii) nondiscriminatory . . . .

47 U.S.C. § 252(d)(1) (emphasis added).

When considered in context, the modifier "the" merely directs the state commission to make its cost determinations based on the particular type of facilities that is "applicable" to that proceeding: *e.g.*, an interconnection as opposed to a local loop or other network element. A state will be determining the cost of providing "the" network element – *e.g.*, a local loop – if it determines the cost that any efficient carrier would incur in constructing and operating local loops in the particular area or type of area. There is nothing in the statutory text that compels a holding that the determinations be made based on the costs specific to the particular incumbent LEC whose facilities will be provided, much less that they be based on the specific "actual facilities" at issue.

For example, almost every State in the nation has a number of different incumbent LECs, with each having previously been franchised exclusively to serve its own separate territories in the State. Under the terms of § 252(d)(1), it is plainly permissible for network element rates to be based on data that is not specific to any of the individual LECs in a state. Rates can be based on statewide average costs of providing facilities in areas with particular population densities, regardless of the specific incumbent LEC that operates within it or the specific "actual facilities" that a specific incumbent LEC has deployed. A state order that set statewide local loop rates on such a basis would be based on the cost of providing "the" network element, and would satisfy the text of the Act, whether or not the determination could be characterized as based on the costs of any LEC's "actual facilities."

By contrast, under the Eighth Circuit's interpretation, states would be required to determine separate rates, on a loop-by-loop basis, for each of the nation's millions of local loops –

with different rates for each loop in, for example, Bethesda, Maryland. For it is then, and only then, that a requesting carrier could be said to be paying rates that are based on what the Eighth Circuit described as the "specifically requested existing network elements that the competitor will in fact be obtaining" from the incumbent LEC. Pet. App. 8a. Statutes cannot be construed to produce such absurdities. *Haggar Co.* v. *Helvering*, 308 U.S. 389, 394 (1940).

2. Further, the Eighth Circuit's construction is wrong even apart from its views on the significance of the use of the modifier "the." Even if word "the" directs the state to the precise "interconnection" or "network element" that has been required, § 252(d) does not require or permit a determination of the cost of providing a LECs' "actual facility." For under the terms of the Act and of the FCC's rules, no incumbent LEC provides an "actual facility" to a requesting carrier. Rather, it provides "features, functions, and capabilities" of facilities that the incumbent LEC owns, operates, and controls.

This follows from the Act's explicit terms. It defines "network element" as either "a facility or equipment used in the provision of a telecommunications service" or "the features, functions, and capabilities that are provided by means of such facility or equipment." 47 U.S.C. § 153(29). The particular network elements that an incumbent LEC is required to "make available" are those which the FCC's regulations designate under the standards of § 251(d)(2). The FCC's Order makes it explicit that it has not required incumbent LEC to provide any actual "facility or equipment" to requesting carriers. Rather, the FCC's Order expressly states that LECs' duty to provide the FCC-designated elements does not "alter the incumbent LEC's physical control" over the facilities nor its "duty to repair and maintain [them]." Order, ¶ 258 (JA 279). Under the FCC's rules, the LEC retains possession and control of the facilities and equipment, and the LEC is providing specific "outputs" or

capacity from its facilities and equipment to the requesting carriers. *Id.* ¶¶ 258-270, 690-695 (JA 278-87). So it quite plainly is the case that, under the FCC's Rules and under the Act, the "network elements" that are being provided are not "actual facilities," but the "features, functions, and capabilities" of the actual facilities that the LEC retains. Similarly, the "interconnections" that LECs provide to new entrants are not actual facilities. Rather, interconnection is the act or function of "physical linking of two networks for the mutual exchange of traffic." *Id.* ¶ 176 (JA 276).

Accordingly, even if the word "the" had the significance that the Eighth Circuits ascribes to it, the question under § 251(d)(1) is what are the "costs" of "providing" the "features, functions, and capabilities" that the new entrant has requested from the LEC. That determination inherently requires judgments that are separate and apart from determining the costs of the "actual facilities" of the incumbent. In all events, the Act can scarcely be said unambiguously to bar the use of a replacement cost method to determine the costs of providing interconnection to the "features, functions, and capabilities" of LECs facilities.

In short, even if TELRIC did not determine the cost of providing the "actual facilities" of an incumbent LEC, the rule would rest on a permissible and manifestly reasonable interpretation of § 252(d)(1) to which the Eighth Circuit was required to defer. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 844 (1984).

C. The Eighth Circuit's Decision Would Require Ratemaking Methods That Either Irrationally Inflate Rates Well Above TELRIC Or Require Rates Far Below TELRIC.

Finally, the Eighth Circuit's decision would require that states set network element rates under methods that either would irrationally inflate rates in ways that have been uniformly condemned or would require rates far less

favorable to LECs than TELRIC. That the Eighth Circuit's decision would require one of two extreme opposing outcomes underscores the reasonableness of the FCC's policy choice.

First, if the FCC did not further modify its regulation on remand, the Eighth Circuit's decision would require states to set interconnection and element rates by attempting to divine the current prices for existing facilities that are approaching obsolescence and that no rational carrier would replicate. In particular, while the Eighth Circuit vacated the subsection of the rule requiring the use of the most efficient available technology, it did not vacate the subsection that prohibits consideration of the historic costs that the incumbent LEC incurred in purchasing the facility and that are recorded in the incumbent LEC's books of account. 47 C.F.R. § 51.505(d)(1). Nor did the Eighth Circuit vacate the subsection that requires the states to calculate the forward-looking cost of the "total quantity of facilities and functions" required to satisfy the current demand for the element. *Id.* § 51.505(b).

Accordingly, as the rule was rewritten by the Eighth Circuit, the only way a state could set rates would be by attempting to establish "up-to-date prices" for the LECs' existing facilities, including their concededly "out-of-date properties." J. Bonbright et al., *Principles of Public Utility Rates* 294 (2d ed. 1988). Indeed, the Eighth Circuit acknowledged the arguments that acceptance of the LECs' claims would require "rates based on the cost of reproducing obsolete technology." Pet. App. 7a.

This is an approach that is "economically meaningless," Bonbright et al., *supra*, at 294, and that has been uniformly condemned. "[T]he 'reproduction cost' to which prices in competitive markets tend to correspond is not the current cost of reproducing the existing plant, brick by brick, but the current cost of producing the *service* with the most modern technology available." 1 A. Kahn, *Economics of Regulation* 112 (2d ed. 1988). As Justice Brandeis explained decades

ago, the efficient replacement cost of the network represents its "maximum value," and the method mandated by the Eighth Circuit's revision to the FCC rule would produce rates that are excessive and would have none of the claimed administrative advantages of a historic cost method in regulating a firm's maximum overall revenues. *Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment). It thus would be patently irrational in the current context of setting the rates for the essential inputs that bottleneck monopolists provide to their retail competitors.

The incumbent LECs cannot and do not defend the use of this method. Instead, they dispute that it is required by the Eighth Circuit's revision of the regulation, and they claim that the Eighth Circuit has simply authorized the setting of rates based on the sum of the historic costs of the LECs' sunk facilities and the incremental costs of modifying them to accommodate new entrants.[26] But the Eighth Circuit squarely and correctly held that such a method is not required by the statutory terms and would be inconsistent with the Act's "stated purpose[]" of promoting competition and efficiency. Pet. App. 10a.

At the other extreme, the Eighth Circuit's decision would permit the FCC – on remand – to adopt methods that are less favorable to incumbent LECs than TELRIC. Indeed, the Eighth Circuit discussed one such approach: short run incremental cost. Under this method, the incumbent LECs would, in the Eighth Circuit's words, recover only costs that the LECs will incur in modifying their networks to allow new entrants to ride "piggyback[]" on the LECs' "existing facilities." Pet. App. 8a. This method would be dramatically less favorable to LECs than TELRIC, for it would allow them

---

[26] Brief in Opposition of BellSouth, SBC, and Verizon, at 11; C.A. Docket No. 1308060-1, Opposition of Qwest Corp. to Respondents' Motion for Partial Stay of Mandate, at 3 n.3.

to recover only "the cost to the [incumbent] LEC of providing that ride" and none of the capital costs of the LEC's network. *Id.*

Such a rule would be consistent with the terms of the Act and could have been adopted by the FCC. However, in its order, the FCC instead pursued the reasonable policy objectives of setting network element rates based on economic costs and maintaining the incentives of new entrants to construct alternate facilities whenever that is economically efficient. For the reasons stated above, Congress plainly gave the FCC the choice of pursuing these objectives.

In sum, TELRIC rests on a reasonable interpretation of § 251(d)(1) to which the Eighth Circuit was required to defer. The entire regulation is valid.

II. THE NETWORK ELEMENT COMBINATIONS RULE IS VALID.

The Eighth Circuit also erred in refusing to reinstate the FCC Rules (51.315(c)-(f)) that require the incumbent LECs to combine network elements in certain circumstances. These rules implement the requirements of § 251(c)(3) of the Act, and are valid under this Court's construction of this provision in *AT&T Corp.* v. *Iowa Utilities Board* – as the Ninth Circuit has held. *U S West Communications* v. *MFS Intelenet, Inc.*, 193 F.3d 1112 (9th Cir. 1999).

Section 251(c)(3) requires incumbent LECs to provide requesting telecommunications carriers access to their "network elements" on an "unbundled" basis on rates, terms and conditions that are "just, reasonable, and nondiscriminatory," and "in a manner that allows requesting carriers to combine such elements in order to provide" telecommunications service. 47 U.S.C. § 251(c)(3). Because there are many instances in which competing carriers using network elements need more than just a single element, network elements are commonly ordered in combinations.

FCC Rules 315(b)-(f) address the incumbent LECs' responsibilities to provide combinations of network elements. Rule 315(b) addresses network elements that the LEC "currently combines" for itself, and prohibits the incumbent from providing such elements to competitors in piecemeal or "separate[d]" form, as opposed to combined form (unless the competitor so requests). 47 C.F.R. § 51.315(b). Rule 315(c), in contrast, addresses LECs' responsibilities to perform the functions necessary to create new combinations of their network elements. It provides that, if certain technical requirements are met and the requesting carrier pays the costs, then "an incumbent LEC shall perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LECs' network." *Id.* § 51.315(c). Rules 315(d)-(f) deal with other aspects of network element combinations, such as the combination of LEC network elements with competitors' network elements, and the assignment of the burden of proof with regard to various technical showings. *Id.* § 51.315(d)-(f).

In its original *Iowa Utilities Board* decision, the Eighth Circuit invalidated all of these rules. Its holdings were based on its constructions of two portions of § 251(c)(3). First, the Eighth Circuit construed the term "unbundled" in the first sentence of § 251(c)(3) to mean "uncombined," and therefore held that "Section 251(c)(3) requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 813 (8th Cir. 1997). Second, it construed the second sentence of § 251(c)(3), which provides that "[a]n incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service," 47 U.S.C. § 251(c)(3). The Eighth Circuit held that its "plain meaning" is that "requesting carriers will combine the unbundled

elements themselves; the Act does not require the incumbent LECs to do *all* of the work." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813.

On review, this Court upheld Rule 315(b), and rejected each of the statutory interpretations on which the Eighth Circuit had relied to strike down all the challenged subparts of Rule 315. First, it held that the term "unbundled" in § 251(c)(3) does not mean "physically separated," but rather means "to give separate prices for equipment and supporting services." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 394.

Second, the Court rejected the Eighth Circuit's interpretation of the "plain meaning" of the second sentence of § 251(c)(3). The Court held that the requirement that the LECs provide network elements in a manner that "allows requesting carriers to combine" them "contemplates that elements *may* be requested and provided" in "discrete pieces," but "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *Id.* This Court held that the combinations requirement of section 251(c)(3) was ambiguous. *Id.* at 395.

Finally, having rejected the grounds for the Eighth Circuit's decision, this Court upheld Rule 315(b) as an "entirely rational" interpretation of the Act, "finding its basis in § 251(c)(3)'s nondiscrimination requirement," which is contained in the first sentence of § 251(c)(3) and which the Eighth Circuit had not discussed. *Id.* As the Court stated, this requirement prohibits incumbent LECs from imposing terms and conditions on the provision of network elements that cause them to incur greater or "wasteful" costs that the incumbents do not themselves incur. *Id.*

Against this background, the Eighth Circuit was plainly wrong in refusing to reinstate Rules 315(c)-(f). Preliminarily, contrary to Eighth Circuit's statement, its prior opinion *did* "employ the same rationale for invalidating subsections (c)-

(f) as [it] did in invalidating subsection (b)." Pet App. 24a.[27] But the decisive fact is that *Iowa Utilities Board* rejected the ground on which the Eighth Circuit previously invalidated subsections (c)-(f) and has now refused to reinstate it: the Eighth Circuit's holding that the "plain meaning" of the second sentence of § 251(c)(3) "indicates that the requesting carriers will combine the unbundled elements themselves" and "does not require the incumbent LECs to do *all* of the work." *Id.* at 25a; *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. As noted, this Court held the phrase to be ambiguous, and under *Chevron* accepted as reasonable the FCC's interpretation that the statutory language "means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service," but "does not impose the obligation of physically combining elements exclusively on requesting carriers," Order, ¶ 294 (JA 296). See *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 394-95.

Nor was the language in this Court's opinion dictum. If the Court had not rejected the Eighth Circuit's interpretation of the second sentence of § 251(c)(3), the Court could not have upheld Rule 51.315(b)'s requirement that incumbents provide existing combinations of elements in combined form. It is the case, by definition, that the requesting carrier does not combine these elements itself and that the incumbent LEC is here "doing all the work." The Court quite plainly held that § 251(c)(3) requires that the terms of access be just, reasonable, and nondiscriminatory, but that this subsection does not speak to the "division of labor" between incumbents and new entrants.

---

[27] Indeed, in the prior opinion, the entire statutory analysis of the combinations requirements was devoted only to subsections (c)-(f). The decision set forth this rationale and then held "[a]ccordingly" that subsection (b) must also fall "because the rule would permit the new entrant access to the incumbent LEC's network elements on a bundled rather than an unbundled basis." *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 813 (8th Cir. 1997).

Finally, in this latter regard, the Eighth Circuit did not – and could not – dispute that Rules 315(c)-(f) are reasonable means of implementing the requirement of the first sentence of § 251(c)(3) that "nondiscriminatory access" be provided on terms that are "just, reasonable, and nondiscriminatory." See *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. at 395. The FCC explained that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbent's network without the assistance of the incumbent." Order, ¶ 293 (JA 296). The FCC thus reasonably concluded that absent such rules "requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements," and refused to impute to Congress the intent to "impos[e] technical obligations on requesting carriers that they might not be able to readily meet." *Id.* There is no reason or basis to question the FCC's determination that requiring technically proficient incumbent LECs to combine their own network elements, with full compensation, was consistent with § 251(c)(3)'s purpose.

The wisdom of the FCC's rules have been borne out in practice. The Eighth Circuit's original decision to invalidate Rules 315(c)-(f) was based on its unsupported assumption that incumbent LECs would "allow entrants access to their networks" in order to perform combinations. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. As the FCC subsequently found, however, "incumbent LECs have refused to provide access to network elements so that competitors could combine them" except in highly limited circumstances. See *Local Competition*, 15 FCC Rcd. 3696, 3910 (¶ 482) (1999).[28] Rule

[28] Thus, in state arbitrations, for example, Bell Atlantic (now Verizon) has warned against allowing competitors' employees "with wire snips and screwdriver in hand, to work on" its equipment, and BellSouth has termed such access "an unwarranted and illegal intrusion." *See* Joint Brief of Intervenors in Support of FCC at 57-59, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir. filed Aug. 16, 1999) (citing incumbent LEC submissions).

315(c) thus represents the only practical way for some network element combinations to be obtained at all.

Moreover, incumbents have taken advantage of the Eighth Circuit's holding to foil competition. The FCC wrote Rule 315 as it did, with the various subparts, to cover comprehensively all scenarios in which network elements might be used in combinations. It sought to ensure that, regardless of the particular combination scenario involved, there would be a level playing field between incumbents and competing carriers and that discriminatory and anticompetitive practices in providing combinations would be prohibited. The FCC employed a single set of legal and policy rationales in support of all Rule 315's subparts (Pet. App. 42a-43a), and the Eighth Circuit's initial decision likewise relied on a single analysis to invalidate all the subparts. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d at 813. But the Eighth Circuit has made a wholly artificial distinction between network elements that the incumbent "currently combines," and those that are not "ordinarily combined." That distinction has, predictably, fostered talmudic disputes over whether various types of network element requests are for combinations that are "new" or "old," or for elements that are "commonly" or "not commonly" combined in the LEC's network. Under the Eighth Circuit's holding, the rights of requesting carriers turn on these meaningless differences.

Those disputes often occur, as would be expected, where the competitive stakes are the highest. For example, a substantial number of customers now order second lines into their homes – for family members, for home offices, for Internet access, or for other reasons – and any carrier that cannot efficiently provision additional lines will be under a substantial competitive disadvantage. However, sometimes the second local loop will not be hooked up to either the incumbent's switch or the customer's premises until the customer places an order for the second line. In those circumstances, incumbent LECs have asserted that they have

no duty to "combine" those network elements if the customer orders service from a competing carrier that uses the incumbent's network elements, even though the incumbent routinely combines the very same elements for itself whenever one of its customers places such an order.

The FCC's adoption of rules for new combinations was an "eminently rational" approach to implementing section 251(c)(3) (*AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. at 395), drawing as it did on the FCC's unique knowledge of the telecommunications industry and judgment regarding the impediments to competition that would otherwise arise. It was not the Eighth Circuit's place to second-guess the agency when Congress did not specifically direct otherwise. This Court should reinstate Rules 315(c)-(f).

CONCLUSION

For the reasons stated, the Eighth Circuit decision should be reversed insofar as it vacated Rules 51.315(c)-(f) and 51.505(b)(1).

Respectfully submitted,

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY & AUSTIN
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner

* Counsel of Record

April 9, 2001

JUL 23 2001

Supreme Court, U.S.
FILED
JUL 23 2001
CLERK

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES

BARBARA D. UNDERWOOD
Acting Solicitor General
Counsel of Record

JOHN M. NANNES
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

BARBARA MCDOWELL
Assistant to the Solicitor General

CATHERINE G. O'SULLIVAN
NANCY C. GARRISON
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

JOHN E. INGLE
Deputy Associate General Counsel

LAURENCE N. BOURNE
Counsel
Federal Communications Commission
Washington, D.C. 20554

QUESTIONS PRESENTED

This Court granted certiorari on the following questions presented in the petition for a writ of certiorari filed by the Federal Communications Commission and the United States (No. 00-587):

1. Whether the court of appeals erred in holding that 47 U.S.C. 252(d)(1) (Supp. IV 1998), a provision of the Telecommunications Act of 1996, forecloses the cost methodology adopted by the Federal Communications Commission for determining the rates that new entrants into local telecommunications markets must pay incumbent local telephone companies for providing interconnection and network elements.

2. Whether 47 U.S.C. 251(c)(3) (Supp. IV 1998) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutory provisions involved	2
Statement	2
Summary of argument	15
Argument:	
I. The FCC's choice of a forward-looking pricing methodology based on the most efficient technology currently available is consistent with the text and purpose of the 1996 Act	20
II. The combinations rules at issue here, like the one upheld in *Iowa Utilities Board I*, are consistent with the text of the 1996 Act and promote Congress's purpose of assuring reasonable and nondiscriminatory access to incumbents' networks	31
Conclusion	46
Appendix	1a

TABLE OF AUTHORITIES

Cases:

AT&T v. *FCC*, 220 F.3d 607 (D.C. Cir. 2000)	43
AT&T v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999)	*passim*
Bell Atlantic-Del., Inc. v. *McMahon*, 80 F. Supp. 2d 218 (D. Del. 2000)	26
BellSouth Corp. v. *FCC*, 162 F.3d 678 (D.C. Cir. 1998)	5
Burlington N. R.R. v. *Surface Transp. Bd.*, 114 F.3d 206 (D.C. Cir. 1997)	25
Chevron U.S.A. Inc. v. *NRDC, Inc.*, 467 U.S. 837 (1984)	11, 21, 40
City of New Orleans v. *FERC*, 67 F.3d 947 (D.C. Cir. 1995)	30-31

Cases—Continued: Page

FPC v. *Texaco, Inc.*, 417 U.S. 380 (1974) 29
Farmers Union Cent. Exch., Inc. v. *FERC*, 734 F.2d 1486 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984) 29
GTE S. Inc. v. *Morrison*, 6 F. Supp. 2d 517 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733 (4th Cir. 1999) 26
GTE Serv. Corp. v. *FCC*, cert. granted, 120 S. Ct. 2214, cert. dismissed, 121 S. Ct. 423 (2000) 15
Iowa Utils. Bd. v. *FCC*, 120 F.3d 753 (8th Cir. 1997) 10, 13, 35, 44
MCI Communications v. *AT&T*, 708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983) 22-23
MCI Telecomms. v. *U.S. West*, 204 F.3d 1262 (9th Cir. 2000) 36
Missouri ex rel. S.W. Bell Tel. Co. v. *Public Serv. Comm'n*, 262 U.S. 276 (1923) 28
Potomac Elec. Power Co. v. *ICC*, 744 F.2d 185 (D.C. Cir. 1984) 25
Strickland v. *Commissioner, Me. Dep't of Human Servs.*, 48 F.3d 12 (1st Cir.), cert. denied, 516 U.S. 850 (1995) 22
Texas Office of Pub. Util. Counsel v. *FCC*, 183 F.3d 393 (1999) 15
US West Communications v. *MFS Intelenet, Inc.*, 193 F.3d 1112 (9th Cir. 1999), cert. denied, 120 S. Ct. 2741 (2000) 14, 36

Constitution, statutes and regulations:

U.S. Const. Amend. V (Takings Clause) 11, 15
Communications Act of 1934, 47 U.S.C. 153(29) (Supp. IV 1998) 4, 16, 27
Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (47 U.S.C. 251 *et seq.*) 2, 3, 21
Title I, 110 Stat. 61:
47 U.S.C. 251 (Supp. IV 1998) 10

Statutes and regulations—Continued: Page

47 U.S.C. 251-253 (Supp. IV 1998) 3
47 U.S.C. 251(c)(2) (Supp. IV 1998) 4, 16
47 U.S.C. 251(c)(2)-(4) (Supp. IV 1998) 3
47 U.S.C. 251(c)(3) (Supp. IV 1998) ..... *passim*
47 U.S.C. 251(c)(4) (Supp. IV 1998) 33
47 U.S.C. 251(d)(2) (Supp. IV 1998) 4, 11
47 U.S.C. 251(d)(2)(A) (Supp. IV 1998) 4
47 U.S.C. 251(d)(2)(B) (Supp. IV 1998) 4
47 U.S.C. 252 (Supp. IV 1998) 10
47 U.S.C. 252(d)(1) (Supp. IV 1998) ..... *passim*
47 U.S.C. 252(d)(1)(A) (Supp. IV 1998) 22
47 U.S.C. 252(d)(3) (Supp. IV 1998) 33
47 U.S.C. 252(e)(5) (Supp. IV 1998) 4
47 U.S.C. 254 (Supp. IV 1998) 15
47 U.S.C. 271 (Supp. IV 1998) 43
Title VI, § 601(a)(2), 110 Stat. 143 (47 U.S.C. 152 note (Supp. IV 1998)) 5
47 C.F.R.:
Section 51.315(b) ..... *passim*
Section 51.315(c) 9, 10, 34, 45
Section 51.315(c)(1) 34
Section 51.315(c)(2) 34
Section 51.315(c)-(f) ..... *passim*
Section 51.315(d) 34
Section 51.315(e) 34
Section 51.315(f) 34
Section 51.505(b)(1) 9, 11, 16, 23, 26, 31, 46

Miscellaneous:

Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act to Provide In-Region, InterLATA Services in the State of New York, 15 F.C.C.R. 3953 (1991) 42-43
Application of BellSouth Corp., et al., for Provision of In-Region, InterLATA Services in Louisiana, In re, 13 F.C.C.R. 20,599 (1998) 42
20 C.J.S. *Cost* (1940) 22

Miscellaneous—Continued:	Page
Comments of the ALTS, CC Dkt. No. 96-98 (filed May 26, 1999)	44
Comments of the Competitive Telecommunications Ass'n, CC Dkt. No. 96-98 (filed May 26, 1999)	44
Commission Recommendation on Interconnection in a Liberalised Telecommunications Market (Pt. 1, Interconnection Pricing), O.J. 1998 L073/42)	25
Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide* (I.C.C. Feb. 8, 1983)	24
Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), aff'd *sub nom. Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444 (3d Cir. 1987)	24, 25
Federal-State Joint Board on Universal Service, Report and Order, In re, 12 F.C.C.R. 8776 (1997)	15, 24
David Gabel & David I. Rosenbaum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239 (2000)	30
Peter Huber, Michael Kellogg & John Thorne, *Federal Telecommunications Law* (2d ed. 1999)	25-26
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, In re, 11 F.C.C.R. 15,499 (1996)	6
Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, In re, 15 F.C.C.R. 3696 (1999), petitions for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, No. 00-1015 et al. (D.C. Cir. Jan. 19, 2000)	11, 35, 41, 42, 43, 44
Industry Analysis Division, FCC:	
Local Telephone Competition: Status as of June 30, 2000 (2000)	2
Local Telephone Competition at the New Millennium (2000)	2

In the Supreme Court of the United States

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (No. 00-587 Pet. App. 1a-43a) is reported at 219 F.3d 744. The *Local Competition Order* of the Federal Communications Commission (FCC) is reported at 11 F.C.C.R. 19,392.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. The government's petition for a writ of certiorari in No. 00-587 was filed on November 29, 2000, and was granted on January 22, 2001. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, are reproduced in the appendix to our petition in No. 00-587 (U.S. Pet. App.) at 104a-125a and in the Joint Appendix (J.A.) at 9-48. In referring to the provisions of the Act, we have cited the 1998 Supplement to the United States Code.

STATEMENT

1. a. Throughout most of the United States, local telephone service has long been dominated by a single incumbent "local exchange carrier," or LEC. That incumbent LEC, whether a regional Bell company or an independent carrier, owns almost all of the loops (the wires that connect telephones to switches) in its service area, along with the switches (which direct calls to their destinations) and the transport trunks (which carry calls between switches). The incumbents' control over those facilities has solidified their de facto monopoly position in most local telecommunications markets. Indeed, even today, after years of efforts to open those markets to competition, incumbents still provide service over approximately 93% of local telephone lines. See Industry Analysis Division, FCC, *Local Telephone Competition: Status as of June 30, 2000*, at 1 (2000); see also Industry Analysis Division, FCC, *Local Telephone Competition at the New Millennium*, Table 6 (2000) (as of December 1999, incumbents controlled approximately 94% of total local telecommunications revenues).

The barriers to entry into local telecommunications markets are different from, and vastly more formidable than, the barriers to entry into the long-distance market. It has been economically practicable for some long-distance carriers to build their own interexchange

infrastructure—*e.g.*, to lay cable or build microwave networks connecting local calling areas to one another —because they can rely (albeit at a cost) on the LECs on either end of an interexchange call to route the call through the various switches and local loops from the call's origin to its destination. But, at least with current technology, it would be economically impracticable for even the largest prospective competitor to duplicate completely the functions of an incumbent LEC's entire network. And, without rights of interconnection, a potential competitor could not gradually enter the market through partial duplication of those functions; a new carrier would win few customers if its customers could call only one another and not customers on the incumbent LEC's separate (and completed) network.

b. "Until the 1990s, local phone service was thought to be a natural monopoly. * * * Technological advances, however, have made competition among multiple providers of local service seem possible." *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 371 (1999). Congress enacted the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56, to open local telecommunications markets to full competition. Congress recognized that no prospective entrant could replicate, at least in the short term, all of an incumbent's existing local network infrastructure. Accordingly, in the local competition provisions of the 1996 Act, 47 U.S.C. 251-253, Congress provided the means for potential competitors to enter local markets by using the incumbents' networks in a variety of ways. See 47 U.S.C. 251(c)(2)-(4).

Central to the local competition provisions is Section 251(c)(3), which entitles a new entrant to gain "access" to (*i.e.*, to lease) an incumbent's "network elements," such as loops, switching capability, and other com-

ponents and capabilities of the incumbent's network. 47 U.S.C. 251(c)(3); see also 47 U.S.C. 153(29) (defining "network element"). That provision permits new entrants, some of which may also have network elements of their own, to lease from an incumbent whatever elements they need to provide services to their own customers.[1] The 1996 Act further permits new entrants to "interconnect" their own facilities with those in the incumbent's network "at any technically feasible point." See 47 U.S.C. 251(c)(2).

An incumbent may charge a new entrant for interconnection and access to network elements. If the incumbent and the new entrant cannot agree on those charges, the state public utility commission, acting as arbitrator, sets the rates that the incumbent may charge.[2] Under the 1996 Act, the state commissions must set rates that are "nondiscriminatory" and "based

---

[1] An incumbent's obligation to lease network elements to new entrants extends only to those elements designated by the FCC under Section 251(d)(2). That provision states that, "[i]n determining what network elements should be made available for purposes of" Section 251(c)(3), the FCC "shall consider, at a minimum," certain competitive standards. 47 U.S.C. 251(d)(2). With respect to most elements, the statutory standard that the FCC must consider is whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer." 47 U.S.C. 251(d)(2)(B); see also 47 U.S.C. 251(d)(2)(A) (providing that, with respect to "proprietary" elements, the relevant standard is whether "access to such network elements * * * is necessary").

[2] A state commission may decline to perform of that statutory role, in which case the FCC would resolve individual disputes between carriers over the rates to be charged for providing interconnection and access to network elements. See 47 U.S.C. 252(e)(5).

on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)." 47 U.S.C. 252(d)(1).[3] The rates "may include a reasonable profit" for the incumbent. *Ibid.* In setting such rates, the state commissions must follow the FCC's pricing rules that give content to that statutory standard. See *Iowa Utils. Bd. I*, 525 U.S. at 383-385. Those are among the rules at issue here.

The 1996 Act also conferred significant benefits on the incumbent LECs. For example, the 1996 Act "relieves the [regional Bell companies] of several of the burdens imposed by the [1982 AT&T consent decree], particularly by prescribing in [47 U.S.C.] § 271 a method whereby [they] can achieve a long-sought-after presence in the long distance market." *BellSouth Corp.* v. *FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (emphasis and citation omitted); see also 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (superseding GTE consent decree). The 1996 Act further entitles incumbent LECs,

---

[3] Section 252(d)(1), titled "Interconnection and network element charges," provides in full:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section—
>
> (A) shall be—
>
> (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
>
> (ii) nondiscriminatory, and
>
> (B) may include a reasonable profit.

like other telecommunications carriers, to invoke its local competition provisions to expand their operations into new geographic areas throughout the United States and compete for the customers of other incumbents.

2. In August 1996, the FCC issued its initial order addressing the most basic issues involving local competition arising under the 1996 Act. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order* (*Local Competition Order*), 11 F.C.C.R. 15,499 (1996). A cornerstone of that order is the FCC's choice of the cost methodology—"total element long-run incremental cost," or TELRIC—that state public utility commissions are to employ in resolving disputes between carriers about the "cost[s]" that Section 252(d)(1) allows the incumbent to recover from the new entrant for providing interconnection and network elements. See *Local Competition Order* (paras. 674-703), J.A. 376-396.

a. TELRIC embodies a "forward-looking" approach to calculating the cost of providing network elements and interconnection. The essential objective of any forward-looking methodology is to determine what it would cost, in today's market, to replace the functions of an asset that make it useful. That is the asset's "forward-looking" cost (also known as its "replacement" or "economic" cost), as distinguished from the cost of duplicating the asset in every physical particular (sometimes called an item's "reproduction" or "replication" cost). Thus, under a forward-looking methodology, if an incumbent bought an analog switch in 1985 at a fixed cost of $150 per line, and an efficient carrier would address the same business needs today by purchasing a digital switch at a fixed cost of $100 per line (more

efficient digital switches have supplanted analog switches in the market), the latter figure is the appropriate basis for determining what a new entrant would pay for leasing switching capacity. Similarly, if a loop cost $100 to install in 1985 but would cost $150 to install today (because, for example, labor costs have increased), the rate for leasing that loop would be based on the higher current cost figure.[4]

The forward-looking purchase price of an asset is only one variable in the TELRIC compensation calculus. TELRIC also takes into account (1) the duration of an element's useful life, as reflected in the applicable depreciation schedule; (2) the cost of capital (*i.e.*, the required return, or profit, on investment); and (3) various types of costs, such as maintenance costs. See *Local Competition Order* (para. 703), J.A. 396. One of TELRIC's principal objectives is to ensure an incumbent's opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives.

The FCC has delegated many of the essential details of implementing TELRIC to the state public utility

---

[4] It cannot be said in the abstract whether a forward-looking approach or a historical approach will producer higher cost figures in a particular setting. Cf. *Iowa Utils. Bd. I*, 525 U.S. at 384 (noting that "[i]t is the States that will * * * implement that methodology [*i.e.*, TELRIC], determining the concrete result in particular circumstances"). Indeed, when the Iowa Utilities Board challenged the FCC's jurisdiction to set prices for network elements, it expressed concern that TELRIC would produce higher, not lower, network element prices in Iowa than would a historical cost methodology. See Mot. of Iowa Utils. Bd. for Stay at 9, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir., filed Sept. 19, 1996).

commissions. For example, the FCC has not set depreciation schedules itself, but has left it to the state commissions to determine, among other things, how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." *Local Competition Order* (para. 686), J.A. 384-385. Similarly, the FCC has given the state commissions great discretion to determine the appropriate cost of capital. *Local Competition Order* (para. 702), J.A. 395-396. The FCC has authorized the state commissions to increase the cost of capital, if warranted, to compensate incumbents for the risk of increased competition. *Ibid.*

The FCC rejected the argument of several incumbent LECs that the 1996 Act entitles them to rates for interconnection and network elements based on the "historical" (or "embedded") costs reflected on their accounting books. The FCC recognized that those costs could be either higher or lower than forward-looking costs. *Local Competition Order* (para. 705), J.A. 398-399. With respect to those circumstances in which historical costs are higher (the only circumstances with which the incumbents were concerned), the FCC reasoned that the use of such costs in determining the rates charged new entrants would be economically arbitrary and would frustrate the competitive objectives of the 1996 Act. See *Local Competition Order* (paras. 704-711), J.A. 397-403.

In asking what it would cost to replace the functions that make an asset valuable, a forward-looking cost methodology requires an inquiry into currently available substitutes—including assets that perform the same functions as the asset in the incumbent's network, but that do not resemble the asset in all re-

spects (*e.g.*, because they embody more efficient technology than the original asset). See pp. 6-7, *supra*. Some incumbents urged the FCC to foreclose any consideration of currently available substitutes in TELRIC. The FCC rejected the incumbents' suggestion as arbitrarily limiting the inquiry into the forward-looking cost of replacing an asset's useful functions in today's market. See *Local Competition Order* (paras. 683-685), J.A. 382-384.

The FCC determined that TELRIC should, however, take as given the incumbent's existing wire centers (*i.e.*, its switch locations), thereby confining the inquiry to efficient alternatives that are compatible with the most basic geographical design of the existing network. *Local Competition Order* (para. 685), J.A. 383-384. The FCC observed that such a limitation would give new entrants additional incentives to save costs by constructing facilities of their own embodying "more efficient network configurations." *Ibid.*

The FCC codified its determinations on this subject in a regulation providing that, for purposes of determining the rates at which an incumbent may lease network elements to a new entrant, an element's cost "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." 47 C.F.R. 51.505(b)(1).

b. At the same time that the FCC promulgated the pricing rules discussed above, the FCC also promulgated another set of rules, which have come to be known as the "combinations" rules. See *Local Competition Order* (paras. 292-297), J.A. 295-299. Rule 315(b) provides that, "[e]xcept upon request, an incumbent LEC shall not separate requested network

elements that the incumbent LEC currently combines." 47 C.F.R. 51.315(b). Rule 315(c)—the principal combinations rule at issue here—further requires incumbent LECs, at the request of a new entrant (and for a cost-based fee), to combine previously uncombined elements, "even if those elements are not ordinarily combined" within the incumbent's network. 47 C.F.R. 51.315(c). This latter rule is designed principally for circumstances in which an incumbent is able to link facilities within its network more efficiently, and thus less expensively, than the new entrant. The new entrant must bear the costs of combination, whether performed by the new entrant itself or by the incumbent; the principal objective of Rule 315(c) is to help the new entrant avoid *unnecessary* costs and delays.

3. a. In 1996 and 1997, the Eighth Circuit stayed and then invalidated the FCC's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the FCC, general jurisdiction to interpret the pricing provisions of Sections 251 and 252. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 794-800 (1997). The Eighth Circuit's jurisdictional orders remained in effect until early 1999. During that period, the great majority of state commissions voluntarily applied the FCC's basic forward-looking methodology in adjudicating disputes between incumbents and new entrants over the rates to be charged for interconnection and network elements. See pp. 25-26, *infra*. In January 1999, this Court reversed the Eighth Circuit's jurisdictional ruling, holding that the FCC has statutory authority to establish national pricing standards under Sections 251 and 252. *Iowa Utils. Bd. I*, 525 U.S. at 376-385. The Court remanded the case to the Eighth

Circuit to address (among other things) the substantive validity of the FCC's cost methodology.[5]

In July 2000, the Eighth Circuit issued its decision on remand. The court upheld the FCC's use of a forward-looking, rather than historical, cost methodology and rejected as premature the incumbents' Takings Clause challenge to that methodology. U.S. Pet. App. 10a-18a. But the court nonetheless invalidated the key regulation specifying that, apart from the "wire center" exception, the forward-looking cost of an element "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration," 47 C.F.R. 51.505(b)(1). U.S. Pet. App. 6a-10a.

The Eighth Circuit held that the regulation was contrary to "the plain meaning" of Section 252(d)(1) and thus did not satisfy step one of this Court's *Chevron* analysis. U.S. Pet. App. 8a; see also *id.* at 4a; see generally *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984) ("First, always, is the question whether Congress has directly spoken to the precise question at issue * * * for the court, as well as the agency, must give effect to the unambiguously ex-

---

[5] This Court separately upheld several of the FCC's rules on the merits but invalidated a portion of the FCC's original implementation of the "necessary" and "impair" standards of Section 251(d)(2), see note 1, *supra*, and remanded to the FCC for further rulemaking. See *Iowa Utils. Bd. I*, 525 U.S. at 387-392. The FCC issued an order on remand in December 1999. See *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking (UNE Remand Order)*, 15 F.C.C.R. 3696 (1999), petitions for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, Nos. 00-1015, et al. (D.C. Cir. Jan. 19, 2000).

pressed intent of Congress."). The court noted that Section 252(d)(1) requires that the determination of the "just and reasonable rate" that an incumbent may charge for interconnection or network elements be based on "the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." U.S. Pet. App. 5a. Emphasizing the word "the" in the final phrase of that provision (*id.* at 7a, 8a), the court concluded that Congress's use of the definite article generally forecloses regulators from looking beyond "the" actual facilities deployed by the incumbent in determining forward-looking costs. *Id.* at 8a-10a.[6]

b. In July 1997, the Eighth Circuit invalidated Rules 315(c)-(f), which require incumbents to combine previously uncombined elements in their networks at the request of new entrants. The court concluded (among other things) that such a requirement was foreclosed by Section 251(c)(3), which states that an incumbent must provide new entrants with "nondiscriminatory access to network elements on an unbundled basis" and "in a manner that allows requesting carriers to combine such elements." The court reasoned that a new entrant's right to "unbundled" elements embodies only a right to "physically separated" elements; that the second sentence of Section 251(c)(3) requires incumbents only to "provide such unbundled network elements in a manner that allows requesting carriers to combine such elements"; and that the plain language of that sentence, by negative implication, precludes provisions that, like Rules 315(c)-(f), require incumbents to provide new combinations of elements to potential competitors. See 120 F.3d at 813. The court did not discuss Rule 315(b). Each side filed petitions for rehearing arguing for or against the proposition that the court's invalidation of Rules 315(c)-(f) compelled the invalidation of Rule 315(b) as well. In October 1997, the court resolved those petitions in favor of invalidating Rule 315(b). See *id.* at 813, 820.

[6] After the Eighth Circuit ruled, the FCC and the United States moved for a partial stay of the mandate pending this Court's disposition of the case, explaining that, if the mandate were to issue immediately, it would cause severe and potentially unnecessary disruption in implementation of the 1996 Act. The Eighth Circuit granted that motion and stayed its mandate, pending this Court's review, with respect to the FCC's pricing rules implementing Section 252(d)(1).

We sought certiorari to challenge the Eighth Circuit's invalidation of Rule 315(b). This Court reinstated Rule 315(b). *Iowa Utils. Bd. I*, 525 U.S. at 393-395. The Court concluded that Section 251(c)(3) "is ambiguous on whether leased network elements may or must be separated," and that Rule 315(b) is an "entirely rational" means for the FCC to "ensur[e] against an anticompetitive practice." *Id.* at 395. In concluding that nothing in Section 251(c)(3) prevented the FCC from adopting that rule, the Court found that the term "unbundled" in Section 251(c)(3) could refer to separately priced assets as distinguished from "physically separated" assets; the Court also found that the second sentence of Section 251(c)(3) "does not say, or even remotely imply, that elements *must* be provided [in discrete pieces] and never in combined form." *Id.* at 394. The Court did not explicitly address Rules 315(c)-(f).

On remand, the FCC and certain private parties asked the Eighth Circuit to restore Rules 315(c)-(f), arguing that this Court's rationale for reinstating Rule 315(b) applied equally to those rules. The Eighth Circuit rejected that request. U.S. Pet. App. 26a-29a.

Once again, the court held that Congress, in the second sentence of Section 251(c)(3), "has directly spoken on the issue of who shall combine previously uncombined network elements," and stated that "[i]t is the requesting carriers who shall 'combine such elements.'" *Id.* at 28a-29a. The court acknowledged that its holding on that point conflicts with a recent decision of the Ninth Circuit, which sustained, as consistent with the 1996 Act, a state public utility commission's imposition of combinations requirements similar to Rules 315(c)-(f). *Id.* at 27a-28a (citing *US West Communications* v. *MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999), cert. denied, 120 S. Ct. 2741 (2000)).

4. The local competition provisions of the 1996 Act are complemented by 47 U.S.C. 254, the provision of the 1996 Act relating to "universal service." For many years, federal and state regulators sought to ensure low rates for subscribers in "high cost" areas through a variety of implicit cross-subsidy mechanisms. For example, incumbent LECs often charged retail rates to customers in densely populated urban areas that well exceeded the cost of serving those customers; those revenues were then used to subsidize the retail rates charged customers in remote rural areas that are much more expensive to serve. Congress recognized that the emergence of local competition would tend to erode the source of such cross-subsidies, as new entrants won the business of customers who would otherwise pay above-cost rates to incumbents. A central objective of Section 254 is to phase out the implicit cross-subsidies and replace them with explicit and competitively neutral funding mechanisms supported by all providers of telecommunications services, including new entrants that provide service through the use of an incumbent LEC's network elements under Section 251(c)(3).

In 1997, the FCC issued rules implementing Section 254 and, among its many other determinations, chose a forward-looking cost methodology similar to TELRIC as a key factor in determining the level of federal funding to supplement state efforts to subsidize affordable service to high cost areas. See *In re Federal-State Joint Board on Universal Service, Report and Order* (*Universal Service Order*), 12 F.C.C.R. 8776 (1997). In 1999, the Fifth Circuit adjudicated various challenges to the *Universal Service Order*. See *Texas Office of Pub. Util. Counsel* v. *FCC*, 183 F.3d 393 (1999). Among its other holdings, that court rejected the argument of certain incumbent LECs that construing Section 254 to permit the use of TELRIC (instead of a historical cost methodology) is barred by the Takings Clause. *Id.* at 413 & n.14. In June 2000, this Court granted a petition for a writ of certiorari on that issue that was filed by GTE, one of the corporate predecessors (along with Bell Atlantic) to Verizon Communications, Inc. See *GTE Serv. Corp.* v. *FCC*, 120 S. Ct. 2214 (No. 99-1244). On November 2, 2000, the Court granted Verizon's unopposed motion to dismiss that case. See 121 S. Ct. 423.

SUMMARY OF ARGUMENT

This case concerns two sets of rules adopted by the FCC to implement the provisions of the 1996 Act that are designed to stimulate competition in local telecommunications markets by giving new entrants a right of access to incumbents' existing networks. One set of rules prescribes the methodology that state public utility commissions are to apply in setting the rates that new entrants must pay in order to interconnect with, and lease elements of, the incumbents' networks. The other set of rules requires that incumbents provide

network elements to new entrants in combined form, if the new entrant requests the combination and agrees to compensate the incumbent for implementing it. Both sets of rules are fully consistent with the text and purpose of the Act, and reflect reasonable policy choices of the expert agency charged with implementing the Act. The court of appeals had no valid basis to set aside any of those rules.

A. In the 1996 Act, Congress sought to encourage the development of competition in local telecommunications markets by enabling new entrants, at rates based on "cost," to interconnect with, and lease elements of, incumbent carriers' existing networks. 47 U.S.C. 252(d)(1); see 47 U.S.C. 251(c)(2) and (3). As the court of appeals recognized, "cost" is a term of some ambiguity. The FCC, after considering various methodologies for determining the costs of providing interconnection and network elements, determined that a methodology based on "forward-looking" costs is both faithful to the Act and necessary to ensure robust local competition.

The forward-looking cost of an asset (*i.e.*, its "economic" or "replacement" cost) reflects the cost, in today's market, of obtaining the functions of the asset that make it valuable. An asset's forward-looking cost necessarily varies with the cost of currently available substitutes that, although not identical to the asset in all respects, perform the same functions. The FCC thus provided that, as a general matter, the forward-looking cost of "network elements" (*i.e.* equipment, facilities, or functions used in the provision of telecommunications service, 47 U.S.C. 153(29)) "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. 51.505(b)(1). The

court of appeals, while upholding the FCC's choice of a methodology based on forward-looking costs, struck down that key rule for measuring such costs.

The court of appeals concluded that the text of the 1996 Act, and specifically Section 252(d)(1), forecloses a methodology that takes into account the costs of efficient, currently available alternatives. But Section 252(d)(1) does not dictate any particular cost methodology. Section 252(d)(1) provides simply that the rate that an incumbent may charge for network elements is to be based on "the cost * * * of providing the * * * network element." That is precisely the cost that the FCC's rule seeks to measure. The FCC's methodology, including its consideration of efficient, currently available alternatives, is directed at determining the forward-looking cost of the element of the incumbent's network that the new entrant seeks to lease. It is not, as the court of appeals apparently believed, directed at determining the cost of something else.

The court of appeals also suggested that the FCC's rule is inconsistent with the 1996 Act because "Congress was dealing with reality, not fantasizing about what might be." U.S. Pet. App. 9a. A primary objective of rate regulation, however, is to establish the price that would exist in a fully competitive market. Given that objective, the more appropriate way to "deal[] with reality" in determining the forward-looking costs of network elements is to take currently available alternatives into account, rather than to pretend that they do not exist. In competitive markets, the price that a firm would pay to lease particular facilities varies with the cost of obtaining the function of those facilities through some other means, including through the use of more efficient substitutes. Taking those substitutes fully into account is not "fantasizing about what might

be," but a routine component of any sensible inquiry into the forward-looking cost of an asset, which approximates the going market price (or current value) of the asset in a competitive market. It is particularly sensible to account for such substitutes when dealing with an industry, such as telecommunications, in which technology changes rapidly.

There is nothing novel about regulators' use of forward-looking cost methodologies that consider the costs of efficient, currently available alternatives. Other federal agencies, with court approval, have employed similar methodologies, based on "hypothetical" costs, for other regulated industries. The FCC's methodology is based on the similar forward-looking methodologies developed by several state public utility commissions, which had already moved to open local telecommunications markets to competition before the enactment of the 1996 Act. Such experience belies concerns, which may underlie the court of appeals' invalidation of the FCC's rule, about the administrability of a forward-looking methodology that considers the costs of efficient, currently available alternatives.

B. The court of appeals also erred in invalidating the FCC's combinations rules, Rules 315(c)-(f), which require incumbent carriers, at the request of a new entrant (and for a cost-based fee), to combine certain elements in their networks that they do not ordinarily combine. Those rules, like the related Rule 315(b) that this Court upheld in *Iowa Utilities Board I*, serve to enforce Congress's mandate that incumbents provide new entrants with "nondiscriminatory access" to network elements. 47 U.S.C. 251(c)(3). Rule 315(b) prohibits an incumbent from separating previously combined network elements over the objection of a new

entrant, whereas Rules 315(c)-(f) allow a new entrant to pay the incumbent to combine previously uncombined network elements in the many instances in which the incumbent may do so more efficiently.

The court of appeals viewed Rules 315(c)-(f) as inconsistent with the second sentence of Section 251(c)(3), which states that an incumbent "shall provide * * * unbundled network elements in a manner that allows requesting carriers to combine such elements." The court drew from that language the negative inference that incumbents cannot be required to provide network elements in combined form. But that sentence simply guarantees new entrants the right, if they so choose, to obtain network elements in a form that allows them to combine those elements themselves. It does not speak to whether the FCC may *also* require incumbents to combine requested network elements when the new entrant is willing to pay for that service. Indeed, the Court expressly rejected the court of appeals' similar reading of that statutory provision in *Iowa Utilities Board I*, recognizing that Section 251(c)(3) "does *not* command th[e] conclusion" that incumbents may be compelled to "leas[e] * * * network elements in discrete pieces" only, and "never in combined form." 525 U.S. at 394 (emphasis added).

Rules 315(c)-(f), like Rule 315(b), are consistent with the text of the 1996 Act, and advance its purpose of encouraging competition in local telecommunications markets. All of those rules are designed to prevent incumbents from imposing unnecessary and often debilitating costs and delays on new entrants that incumbents would not incur when serving their own retail customers—costs and delays that the FCC found could significantly undermine the utility of new entrants' statutory right to enter the marketplace

through the leasing of network elements. The FCC's choice in Rules 315(c)-(f), as in Rule 315(b), to "opt in favor of ensuring against an anticompetitive practice" that incumbents may employ against new entrants "is well within the bounds of the reasonable." *Iowa Utils. Bd. I*, 525 U.S. at 395.

ARGUMENT

I. THE FCC'S CHOICE OF A FORWARD-LOOKING PRICING METHODOLOGY BASED ON THE MOST EFFICIENT TECHNOLOGY CURRENTLY AVAILABLE IS CONSISTENT WITH THE TEXT AND PURPOSE OF THE 1996 ACT

In the 1996 Act, Congress directed that the rate that an incumbent LEC may charge a new entrant for leasing a network element "shall be based on the cost * * * of providing the * * * network element." 47 U.S.C. 252(d)(1). In the order under review here, the FCC made two critical decisions in implementing that statutory standard. First, the FCC determined that the "cost" of "providing" a network element is the *forward-looking* ("economic" or "replacement") cost of the element, *i.e.*, the cost of replacing the features or functions of the element on today's market, not whatever "historical" costs might be reflected on a particular incumbent's accounting books. Second, the FCC determined that ascertaining an element's forward-looking cost involves consideration of the cost of any efficient alternatives currently available on the market, not just alternatives that are physically identical to the facilities currently in place. See *Local Competition Order* (paras. 672-707), J.A. 375-401. In each instance, the FCC made a reasonable policy choice, in an area of its expertise, on a matter that Congress left for the

FCC to resolve. See *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-845 (1984).

The court of appeals sustained the first of the FCC's determinations but erroneously rejected the second as inconsistent with the text of the 1996 Act. The court had no basis under *Chevron* to decline to defer to either determination. The FCC's recognition that a forward-looking cost methodology must consider efficient, currently available alternatives, like the FCC's choice of that methodology itself, not only comports with Congress's language, but also advances Congress's purpose of promoting competition in local telecommunications markets. See 1996 Act, preamble, 110 Stat. 56. Indeed, a forward-looking cost inquiry that does *not* take into account the costs of efficient available alternatives would, like a historical cost inquiry, produce rates that turn on choices that a particular incumbent made in the past about which equipment to install or when to install it. It would ignore factors relevant to any carrier's present choices in a competitive market with respect to entry, expansion, and pricing.[7]

1. Congress provided that the "just and reasonable rate" at which an incumbent LEC may lease a network element to a new entrant is a rate "based on the cost * * * of providing the * * * network element." 47

---

[7] At the same time that the Court granted our petition for certiorari in this case, the Court granted the petition of Verizon Communications, Inc., in No. 00-511, which challenges the FCC's choice of a pricing methodology based on forward-looking, as opposed to historical, costs. It is necessary to discuss the FCC's decision to adopt a forward-looking methodology in order to explain why such a methodology necessarily, and appropriately, entails a consideration of efficient, currently available alternatives. We will, however, defer our full discussion of that methodology until our response to Verizon's brief on the merits.

U.S.C. 252(d)(1)(A). As the court of appeals recognized, Congress did not itself prescribe how that "cost" is to be determined; rather, Congress left it to the FCC to consider which of the several methodologies for determining "cost" would most appropriately serve the purposes of the 1996 Act. See U.S. Pet. App. 11a ("We conclude the term 'cost,' as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context."); cf. *Strickland* v. *Commissioner, Me. Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir.) (describing the term "cost" as "one of equivocal meaning") (quoting 20 C.J.S. *Cost* (1940)), cert. denied, 516 U.S. 850 (1995).

The FCC, in determining that the appropriate "cost" of providing a network element, for purposes of 47 U.S.C. 252(d)(1), is the forward-looking cost of that element, found guidance in the central purposes of the 1996 Act: to bring meaningful competition to local telecommunications markets; to ensure the efficient use of existing network facilities, many of which embody significant economies of scale and scope; and to encourage new entrants to make economically rational decisions about whether, or how, to enter a given local market. See *Local Competition Order* (paras. 620, 630, 679, 705-706), J.A. 327-328, 333-334, 379-380, 398-399. The FCC explained that a forward-looking methodology emulates rational economic behavior in a competitive market; a firm considers forward-looking costs, not historical costs, in making decisions about entry, expansion, and price. See *Local Competition Order* (paras. 620, 679, 740), J.A. 327-328, 379-380, 422-423; see also *MCI Communications* v. *AT&T*, 708 F.2d 1081, 1116-1117 (7th Cir.) ("[I]t is current and anticipated cost, rather than historical cost that is relevant to business decisions to enter markets."), cert. denied, 464

U.S. 891 (1983); U.S. Pet. App. 12a (acknowledging that "[f]orward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the Act"). The FCC thus concluded that a forward-looking methodology would send appropriate signals for entry, investment, and innovation to potential competitors in local telecommunications markets. See *Local Competition Order* (paras. 620, 630), J.A. 327-328, 333-334.

Any inquiry into forward-looking costs asks how much it would cost, in today's market, to replace the functions of an item that make it valuable. See pp. 6-9, *supra*. An item's forward-looking cost, like its fair market value, necessarily varies with the cost of currently available substitutes that perform the item's functions. For example, the forward-looking cost (as well as the fair market value) of a personal computer, a video cassette recorder, or a telephone switch declines as more efficient substitutes are introduced into the market; those substitutes, although performing the same functions as the original item, may not resemble the original item in every physical particular. That principle is embodied in the key regulation at issue here, which provides that, as a general matter, forward-looking cost "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. 51.505(b)(1).[8]

---

[8] As noted above (p. 9), however, the FCC directed that the inquiry into forward-looking costs is to take as given "the existing location of the incumbent LEC's wire centers" (*i.e.*, switch locations). 47 C.F.R. 51.505(b)(1); see *Local Competition Order* (paras. 683-685), J.A. 382-384. That pragmatic limitation serves to confine the forward-looking cost inquiry to those efficient alternatives that are compatible with the most basic geographic

There is nothing novel about regulators' use of forward-looking cost methodologies that take into account the costs of efficient, currently available alternatives. Other federal agencies, with court approval, have employed similar methodologies, based on "hypothetical" costs, to govern other regulated industries. In the 1980s, for example, the Interstate Commerce Commission employed a forward-looking cost methodology based on "most efficient" alternatives to determine the maximum rate that a market-dominant railroad could charge a coal shipper that was the "captive" of that railroad.[9]

---

structure of the existing network. It also enabled the state public utility commissions and the industry to employ existing forward-looking cost models, which typically incorporated a wire-centers limitation as part of their methodology. See generally *Universal Service Order*, 12 F.C.C.R. at 8903-8905. And the FCC observed that this limitation, by encouraging new entrants to save costs "by designing more efficient network configurations," would provide an incentive for new entrants to construct their own facilities. *Local Competition Order* (para. 685), J.A. 383-384.

[9] Under the ICC's standard, the railroad could charge the captive shipper no more than the "stand alone" cost of transporting the coal, defined as the forward-looking cost that the shipper itself would incur were it to transport the coal to its destination using the most efficient railroad system that could be configured to accomplish that task. See Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-546 (1985), aff'd *sub nom. Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444, 1451, 1457 (3d Cir. 1987); see also Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, slip op. 10-13 (unpublished decision issued Feb. 8, 1983) (delineating substantially similar interim standard). The D.C. Circuit, in an opinion joined by then-Judge Scalia, upheld the ICC's use of that methodology. The court reasoned that, although the methodology "deals with hypothetical and not actual transportation situations, it provides an appropriate analytical tool for determining whether a return on noncompetitive

The FCC based TELRIC on the similar, and similarly "hypothetical," forward-looking cost methodologies developed by several state public utility commissions that had already taken steps to open local markets to competition. *Local Competition Order* (paras. 631, 681), J.A. 334-336, 381. The European Commission has endorsed a cost methodology similar to TELRIC—based on a model hypothesizing "an efficient operator employing modern technology"—as a means of opening European telecommunications markets to competition.[10]

Moreover, during the period from 1996 through early 1999 when the FCC's pricing rules were stayed and then vacated by the Eighth Circuit on jurisdictional grounds (see p. 10, *supra*), the overwhelming majority of state public utility commissions independently and voluntarily embraced the essentials of TELRIC, including its consideration of efficient available alternatives, in their implementation of the local-competition provisions of the 1996 Act. See Peter Huber, Michael Kellogg & John Thorne, *Federal Telecommunications Law* § 2.4.4.1, at 185 (2d ed. 1999) ("While the *Iowa*

---

traffic 'properly reflects the high demand for the service, but is not set at an unreasonably high or "monopoly" level.'" *Potomac Elec. Power Co.* v. *ICC*, 744 F.2d 185, 193-194 (D.C. Cir. 1984) (quoting interim ICC Guidelines); see also *Consolidated Rail Corp.*, 812 F.2d at 1453-1457 (affirming in full final ICC guidelines); *Burlington N. R.R.* v. *Surface Transp. Bd.*, 114 F.3d 206, 212-215 (D.C. Cir. 1997) (affirming Surface Transportation Board's application of those guidelines).

[10] See *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market (Pt. 1, Interconnection Pricing)*, O.J. 1998 L073/42 ("Interconnection costs should be calculated on the basis of forward-looking long run average incremental costs, since these costs closely approximate those of an efficient operator employing modern technology.").

Utilities Board case was being litigated, most states used their price-setting authority in ways closely following the FCC models.").[11] The federal courts have consistently endorsed that choice on the merits in their review of the state commissions' actions. See, *e.g.*, *GTE S. Inc.* v. *Morrison*, 6 F. Supp. 2d 517, 528-530 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-744, 749 (4th Cir. 1999); see also *Bell Atlantic-Del., Inc.* v. *McMahon*, 80 F. Supp. 2d 218, 235-236 (D. Del. 2000).

2. While affirming the FCC's choice of a forward-looking cost methodology, the Eighth Circuit rejected, as contrary to the text of Section 252(d)(1), the FCC's explanation of what that methodology should measure —*i.e.*, that, for the most part, forward-looking cost "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. 51.505(b)(1). Contrary to the Eighth Circuit's conclusion, just as Congress left it to the FCC to define "cost" for purposes of Section 252(d)(1), Congress left it to the FCC to determine how that "cost" should be calculated. Nothing in Congress's directive that "the just and reasonable rate for network elements * * * shall be based on the cost * * * of providing the * * * network element," 47 U.S.C. 252(d)(1), forecloses consideration of efficient, currently available alternatives.

The Eighth Circuit gave little explanation for its holding beyond the twin observations that (1) "Congress intended the rates to be 'based on the cost . . . of *providing the interconnection or network element*'" requested by a new entrant and (2) "Congress was dealing with reality, not fantasizing about what might be." U.S. Pet. App. 8a-9a. Neither observation, however, is at all inconsistent with the FCC's methodology.

First, the Eighth Circuit appears, at the outset, to have misconstrued the statutory term "network element." Congress used that term to describe, at an appropriately high level of generality, the *class* of "facilit[ies]" (or "features, functions, and capabilities") associated with particular tasks within the network. See 47 U.S.C. 153(29) (defining "network element"); see *Iowa Utils. Bd. I*, 525 U.S. at 387 (concluding, given "the breadth of this definition," that the term "network element" is not limited to "physical facilities and equipment," but includes such "features, functions, and capabilities" as directory assistance, caller I.D., and call forwarding). For example, fiber wires and copper wires, despite their physical differences, are both examples of the loop element because they serve the same function. See *Local Competition Order* (para. 380), J.A. 310-311. Similarly, analog switches and digital switches are both examples of the switching element. See *Local Competition Order* (para 412), J.A. 323-324. The Eighth Circuit's decision, however, seems to rest on the erroneous premise that the term "element" is confined to individual pieces of equipment.

Second, the Eighth Circuit apparently thought that regulators, in considering the costs of efficient substitutes, are determining the forward-looking cost of something *other than* the underlying "network element" whose functions the new entrant seeks to obtain. That is simply wrong. As the Eighth Circuit itself recognized, the "cost" inquiry mandated by Section

[11] Similarly, in their brief opposing the FCC's petition for certiorari on the jurisdictional question in *Iowa Utilities Board* (on the ground that the question was not of sufficient national importance), the Bell companies appeared to acknowledge that "'virtually every state in the union' has adopted pricing policies compatible with the FCC's own notions." Reg'l Bell Operating Cos. Br. in Opp. at 19-20, *Iowa Utils. Bd. I*, Nos. 97-826, et al.

252(d)(1) is reasonably construed to permit an inquiry into forward-looking cost. The forward-looking cost of an asset turns on the cost of replacing the *functions* of the asset, an inquiry that necessarily entails consideration of any efficient, currently available substitutes that perform those same functions. By definition, then, that inquiry requires examination of the current cost of obtaining those substitutes.[12]

Perhaps the Eighth Circuit thought that the forward-looking inquiry should turn on the cost of replicating an incumbent's existing facilities in every physical particular (rather than simply replacing their functions), whether or not any rational actor would construct such facilities in today's market. But nothing in the language of Section 252(d)(1) remotely compels the adoption of that wooden and long-discredited methodological approach. See *Local Competition Order* (para. 684), J.A. 383 (recognizing that such an approach could produce rates "that reflect inefficient or obsolete network design and technology"); see also *Missouri ex rel. S.W. Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., dissenting) (disparaging, as the *least* appropriate cost methodology, an inquiry into "what it would cost to reproduce the identical property").

Third, contrary to the Eighth Circuit's suggestion, the more appropriate way to "deal[] with reality" (U.S.

---

[12] To take an example from common experience, a real estate appraiser is still determining the fair market value of one's own house (and not somebody else's), even though the appraiser takes into account the prices at which comparable houses in the neighborhood have sold. Similarly, here, a utility regulator is still determining the forward-looking cost of the incumbent's own facilities, even though the regulator takes into account the costs of other facilities that perform the same functions.

Pet. App. 9a) in determining the forward-looking costs of network elements is to take currently available alternatives into account, rather than to pretend that they do not exist. The central objective of rate regulation has traditionally been to "restore the 'true' market price — the price that would result through the mechanism of a truly competitive market." *Farmers Union Cent. Exch., Inc.* v. *FERC*, 734 F.2d 1486, 1510 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984); see, *e.g.*, *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 397-398 (1974). In competitive markets, the price that a firm would pay or charge to lease particular facilities varies with the cost of obtaining the function of those facilities through some other means, including through the use of more efficient substitutes; the firm would not arbitrarily blind itself to the availability of such substitutes.

Thus, taking efficient substitutes fully into account is not, as the Eighth Circuit stated, "fantasizing about what might be." It is instead a routine component of any sensible inquiry into the forward-looking cost of an asset, which approximates the going market price (or current value) of the asset in a competitive market. Indeed, it would be unrealistic, in conducting such an inquiry, to omit any consideration of efficient substitutes and to proceed on the assumption that technology has frozen in time and has no bearing on the cost of replacing the functions of an asset. That is particularly true with respect to an industry, such as the telecommunications industry, in which technology changes so rapidly.

An unstated premise of the Eighth Circuit's ruling may have been that an inquiry into the cost of obtaining a given function with "the most efficient telecommunications technology currently available," rather than the technology actually employed by the incum-

bent, would be unduly difficult to administer.[13] We intend to address the administrability of TELRIC generally in our response to Verizon's challenge to that methodology. See note 7, *supra*. The short answer, however, is that regulators and businesses have been engaging, for some years, in inquiries into the costs of efficient available alternatives. See pp. 24-25, *supra*; *Local Competition Order* (para. 681), J.A. 381 ("disagree[ing]," based on the experience of "[a] number of" state commissions with similar forward-looking methodologies, that "the information required to compute prices based on forward-looking costs is inherently so hypothetical as to be of little or no practical value"); David Gabel & David I. Rosenbaum, *Who's Taking Whom: Some Comments And Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239, 256-257 (2000) (noting examples of telecommunications companies' using forward-looking methodologies in their own pricing decisions well before the FCC's adoption of TELRIC, including BellSouth's use of an analysis that "assumed that the network engineer will * * * select[] the most economically efficient technology"). Moreover, all cost methodologies, including those based on historical costs, involve inquiries that are to some extent "hypothetical." A historical cost methodology, for example, entails inquiries into, among other things, whether, and to what extent, the investments made by a regulated entity in the past were prudent. See, *e.g.*, *City of New Orleans* v. *FERC*, 67 F.3d 947, 954 (D.C.

[13] The Eighth Circuit did not describe what sort of forward-looking methodology it would consider permissible under the 1996 Act. Nor has such a description yet been offered by the incumbent LECs, such as Verizon, which oppose *any* forward-looking methodology.

Cir. 1995). And a replication or reproduction cost methodology entails inquiries into the cost, in today's market, of duplicating the precise facilities that were constructed years ago and that may since have become obsolete or unavailable.

In sum, the FCC's determination that the forward-looking cost inquiry must consider the costs of efficient, currently available alternatives is consistent with the text of Section 252(d)(1) and reasonably seeks to advance the 1996 Act's pro-competitive purposes. The court of appeals thus erred in invaliding 47 C.F.R. 51.505(b)(1).

II. THE COMBINATIONS RULES AT ISSUE HERE, LIKE THE ONE UPHELD IN *IOWA UTILITIES BOARD I*, ARE CONSISTENT WITH THE TEXT OF THE 1996 ACT AND PROMOTE CONGRESS'S PURPOSE OF ASSURING REASONABLE AND NONDISCRIMINATORY ACCESS TO INCUMBENTS' NETWORKS

The Eighth Circuit also erred in vacating the FCC's Rules 315(c)-(f) governing the combination of network elements. See 47 C.F.R. 51.315(c)-(f). The court of appeals' ruling is predicated on a strained "plain language" reading of the statute that is, in all pertinent respects, indistinguishable from the analysis that this Court rejected in *Iowa Utilities Board I*, 525 U.S. at 394-395. The FCC's rules, by contrast, reflect a reasonable reading of ambiguous statutory language and promote the purposes of the statute by deterring a species of discriminatory conduct by incumbents against new entrants.

1. a. Rules 315(c)-(f) are part of a package of regulations implementing the important provision of the

1996 Act, codified at 47 U.S.C. 251(c)(3), that requires incumbent LECs to grant new entrants access to network elements for a just and reasonable cost-based fee. Those regulations also include Rule 315(b), which was upheld by this Court in *Iowa Utilities Board I*.

Section 251(c)(3) provides, in pertinent part, that each incumbent LEC has:

> [t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory * * *. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

47 U.S.C. 251(c)(3); see *Iowa Utils. Bd. I*, 525 U.S. at 394-395 (discussing Section 251(c)(3)).

Section 251(c)(3) thus grants new entrants the right, among other things, to lease network elements on an "unbundled" basis—that is, to select those elements that they need, without also being forced to use and pay for elements that they do not need or that they can more efficiently provide themselves or obtain elsewhere. See *Iowa Utils. Bd. I*, 525 U.S. at 394-395. New entrants often need more than just a single network element, however. In those instances in which new entrants need "combinations" of network elements, the additional mandate of Section 251(c)(3) that incumbents offer "nondiscriminatory access" on "reasonable" terms prohibits incumbents from imposing arbitrary and

economically wasteful limitations on access that would not apply to their own retail operations.

Section 251(c)(3) serves a crucial role in opening local markets to competition. Virtually no competitor, with current technology, could replicate an incumbent's entire network, at least in the short term. While resale is one competitive option, that option limits new entrants to competing only on price, and only within the margin between the incumbent's retail price and the wholesale discount required under 47 U.S.C. 251(c)(4) and 252(d)(3). See *Local Competition Order* (para. 332), J.A. 307. Access to unbundled network elements, on the other hand, provides new entrants with the ability to compete broadly with incumbents, not just as to price, but also as to product, since network elements may be capable of performing functions that incumbents have not chosen to offer to their retail customers, but that new entrants may incorporate into their own offerings. See *Local Competition Order* (paras. 332-333), J.A. 307-308.

b. The FCC adopted its various combinations rules to implement comprehensively the nondiscrimination mandate of Section 251(c)(3) in the varied instances in which a new entrant might require more than one network element. Rule 315(b), the first in the package of combinations rules, applies to *existing* network element combinations, *i.e.*, those that the incumbent LEC "currently combines" for itself. Rule 315(b) prohibits the incumbent, "[e]xcept upon [the competitor's] request," from disconnecting those network elements and providing them only in "separate[d]" form. 47 C.F.R. 51.315(b). As the Court recognized in *Iowa Utilities Board I*, Rule 315(b) enforces the nondiscrimination mandate of Section 251(c)(3) by "preventing incumbent LECs from 'disconnect[ing] previously con-

nected elements * * * not for any productive reason, but just to impose wasteful reconnection costs on new entrants.'" 525 U.S. at 395.

Rules 315(c)-(f), the remaining combinations rules, address the incumbent LEC's duty to provide new entrants with a meaningful opportunity to obtain *new* combinations of existing network elements. That duty is set out principally in Rule 315(c), which requires an incumbent LEC, at the request of a new entrant and for a reasonable cost-based fee, to combine network elements "even if those elements are not ordinarily combined" within the incumbent's network. 47 C.F.R. 51.315(c).[14] Rule 315(c) advances the nondiscrimination requirement of Section 251(c)(3) by allowing new entrants to pay the incumbent to combine network elements in the many instances in which the incumbent may do so more efficiently, thereby enabling new entrants to avoid unnecessary and often debilitating costs and delays that an incumbent would not suffer

[14] The duty set forth in Rule 315(c) applies only where the requested combination is "[t]echnically feasible" and only where compliance with the request "[w]ould not impair the ability of other carriers to obtain access to unbundled network elements or to interconnect with the incumbent LEC's network." 47 C.F.R. 51.315(c)(1) and (2). Rules 315(d), (e), and (f) supplement or clarify the basic obligation of Rule 315(c) in various ways that the Eighth Circuit did not consider independently problematic. Rules 315(e) and (f) provide state public utility commissions with specific guidance on the application of the two qualifications to the general duty stated in Rule 315(c). 47 C.F.R. 51.315(e) and (f). Rule 315(d) imposes on incumbent LECs a related duty to "perform the functions necessary to combine unbundled network elements with elements possessed by the requesting telecommunications carrier in any technically feasible manner." 47 C.F.R. 51.315(d). In all cases, the requesting carrier would have to pay the reasonable cost of effecting a combination.

when serving its own retail customers. See *Local Competition Order* (paras. 293-294), J.A. 295-297; see also *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking* (*UNE Remand Order*), 15 F.C.C.R. 3696, 3909-3910 (1999) (para. 481), petitions for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, Nos. 00-1015, et al. (D.C. Cir. Jan. 19, 2000).

c. In its first *Iowa Utilities Board* decision, the Eighth Circuit struck down all of the FCC's combinations rules based on a single integrated analysis. See 120 F.3d at 813. Focusing on two portions of Section 251(c)(3), the court of appeals ruled that—whether one considers network elements that are already combined by an incumbent LEC or new combinations of network elements sought by a competitor—the FCC had no statutory basis to require incumbents to provide new entrants with access to network elements in combined form. The Eighth Circuit reasoned, first, that the term "unbundled" in the first sentence of Section 251(c)(3) means disconnected or "uncombined," and that Section 251(c)(3) therefore "requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis." *Ibid.* Second, drawing a negative inference from language in the second sentence of Section 251(c)(3) that requires incumbents to provide access to network elements "in a manner that allows requesting carriers to combine such elements," the court of appeals concluded that the provision "unambiguously indicates that requesting carriers will combine the unbundled elements themselves." *Ibid.*

On review of that decision in *Iowa Utilities Board I*, this Court reinstated Rule 315(b), the only one of the

combinations rules then before the Court, while rejecting the court of appeals' rationale for striking down all of the combinations rules. First, the Court disagreed with the court of appeals' construction of the statutory term "unbundled" as meaning "physically separated," noting that "the only [dictionary] definition given * * * matches the FCC's interpretation of the word: 'to give separate prices for equipment and supporting services.'" *Iowa Utils. Bd. I*, 525 U.S. at 394. Second, the Court found that the requirement in the second sentence of Section 251(c)(3) that incumbents provide access to network elements in a manner that "'allows requesting carriers to combine' them * * * does not say, or even remotely imply, that elements *must* be provided only [in discrete pieces] and never in combined form." *Ibid.* To the contrary, the Court found that Rule 315(b), with its purpose of preventing incumbent LECs from "impos[ing] wasteful reconnection costs on new entrants," is an "entirely rational" application of Section 251(c)(3)'s nondiscrimination requirement. *Id.* at 395.

Because this Court's decision in *Iowa Utilities Board I* with respect to Rule 315(b) undermines the Eighth Circuit's rationale for invalidating all of the combinations rules, the FCC and others asked the court of appeals on remand to reinstate Rules 315(c)-(f).[15] In response, the court of appeals reconsidered the validity

[15] In the interim, the Ninth Circuit concluded that this Court's reasons for upholding Rule 315(b) apply equally to, and thus had undermined the Eighth Circuit's analysis with respect to, combinations requirements such as those contained in Rules 315(c)-(f). See *US West Communications* v. *MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999), cert. denied, 120 S. Ct. 2741 (2000); *MCI Telecomms.* v. *U.S. West*, 204 F.3d 1262, 1268 (9th Cir. 2000).

of Rules 315(c)-(f),[16] but ultimately reaffirmed its original holding that those Rules "violate the plain language" of Section 251(c)(3). U.S. Pet. App. 29a.

2. The court of appeals' decision on remand once again to invalidate Rules 315(c)-(f) on the basis of an alleged plain language reading of Section 251(c)(3) conflicts with this Court's reading of that provision in *Iowa Utilities Board I*. Nothing in Section 251(c)(3) gives incumbent LECs the right to force new entrants to combine network elements themselves, even when the incumbents can do the combining more efficiently and the new entrants will pay the incumbents to do so. To the contrary, the FCC has ample authority to prohibit such conduct in light of Congress's directive in Section 251(c)(3) that an incumbent provide new

[16] See Order at 2-3, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir. June 10, 1999) ("The briefs should also address whether or not, in light of the Supreme Court's decision, this court should take any further action with respect to * * * § 315(c)-(f)."). In opposing our petition for certiorari and those of other parties with respect to this question, Verizon suggested that we "forfeited" our opportunity to challenge the court of appeals' invalidation of Rule 315(c)-(f) by not having done so in *Iowa Utilities Board I*. See Verizon et al. Br. in Opp. 13-16, *WorldCom, Inc.* v. *Verizon Communications, Inc.*, Nos. 00-555, et al. For reasons that we explained in our reply brief at the petition stage, our decision not to seek review of the court of appeals' invalidation of Rules 315(c)-(f) in *Iowa Utilities Board I* should not preclude our doing so now, especially given the emergence of a circuit conflict, acknowledged by the court of appeals in this case, concerning the scope of the duty to provide access to network element combinations under Section 251(c)(3). See No. 00-587 U.S. Reply Br. 6-8. Indeed, the Eighth Circuit itself reopened the question of the validity of Rules 315(c)-(f) after this Court's decision in *Iowa Utilities Board I* and ruled anew on that question in the decision on review here. This Court granted certiorari on that question. See Order 3-4, *Verizon Communications* v. *FCC*, Nos. 00-511, et al. (Jan. 22, 2001).

entrants with "nondiscriminatory access" to its network and Congress's overriding purpose in the 1996 Act to stimulate competition in local telecommunications markets.

a. On remand, the court of appeals again focused, as it had in its earlier decision invalidating the combinations rules, on the second sentence of Section 251(c)(3), which states that an incumbent LEC must provide unbundled elements "in a manner that allows requesting carriers to combine such elements." U.S. Pet. App. 28a (quoting 47 U.S.C. 251(c)(3)). The court reasoned that "Congress has directly spoken on the issue of who shall combine previously uncombined network elements," and that "[i]t is the requesting carriers who shall 'combine such elements.'" *Id.* at 28a-29a. The court was mistaken.

The statutory sentence upon which the court of appeals relied simply guarantees new entrants the right, if they so choose, to obtain network elements in a form that allows them to combine the network elements themselves. It does not speak to whether the FCC may *also* require incumbents to combine requested network elements when the new entrant is willing to pay for that service. Indeed, this Court expressly addressed the same statutory language in *Iowa Utilities Board I*. The Court recognized that, although the second sentence of Section 251(c)(3) "contemplates that elements *may* be requested and provided" in "discrete pieces," it "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." 525 U.S. at 394. Similarly, there is no basis here to conclude that, because that same sentence confers on new entrants the right to combine elements of the incumbent's network, it precludes the FCC from issuing rules recognizing a new entrant's additional

right to have an incumbent combine those elements for a cost-based fee. Cf. *id.* at 397 (recognizing that "[w]e can only enforce the clear limits that the 1996 Act contains").

The court of appeals sought to distinguish the question presented in *Iowa Utilities Board I* with respect to Rule 315(b), which the court characterized as "whether the [1996] Act prohibited the combination of network elements," from the question presented on remand with respect to Rules 315(c)-(f), which the court characterized as "*who* shall be required to do the combining." U.S. Pet. App. 28a. But none of the combinations rules presents the question whether Section 251(c)(3) *prohibits* the combination of network elements (even if a new entrant requests a combination and the incumbent is willing to provide it). The incumbents would not have asked for such a ruling, which would curtail their own freedom to provide combinations when it suits them, and Section 251(c)(3) could not plausibly be read to impose such a prohibition. Instead, all of the combinations rules, Rule 315(b) as well as Rules 315(c)-(f), raise the same question of "*who* shall be required to do the combining," whether the combination is an existing one made by the incumbent for its own business purposes (the circumstance addressed by Rule 315(b)) or is a new one that the new entrant requests and compensates the incumbent for making (the circumstance addressed by Rules 315(c)-(f)). This Court's determination that the second sentence of Section 251(c)(3) "does not say, or even remotely imply" that incumbents cannot be required to provide network elements in combined form, *Iowa Utils. Bd. I*, 525 U.S. at 394, vitiates the "plain language" basis for the court of appeals' ruling on remand.

b. In *Iowa Utilities Board I*, after concluding that Rule 315(b) satisfies step one of the *Chevron* analysis because "§ 251(c)(3) is ambiguous on whether leased network elements may or must be separated," the Court considered whether Rule 315(b) also satisfies step two of that analysis. See *Chevron*, 467 U.S. at 845 (once a count determines that Congress did not express its intent on a given issue, the only question that remains is whether the agency's resolution of that issue "is a reasonable one"). The Court recognized that Rule 315(b), which "find[s] its basis in § 251(c)(3)'s nondiscrimination requirement," is designed to prevent incumbent LECs from disconnecting previously combined network elements "not for any productive reason, but just to impose wasteful reconnection costs on new entrants." *Iowa Utils. Bd. I*, 525 U.S. at 395. The Court concluded that "[i]t is well within the bounds of the reasonable for the Commission to opt in favor of ensuring against [that] anticompetitive practice" by promulgating Rule 315(b). *Ibid.*

The same analysis should apply here. Rules 315(c)-(f), like Rule 315(b), are based on Section 251(c)(3)'s requirement that incumbent LECs provide "nondiscriminatory access" to their networks on "reasonable" terms and conditions. Moreover, Rules 315(c)-(f), like Rule 315(b), are designed to "ensur[e] against an anticompetitive practice" of incumbents. *Iowa Utils. Bd. I*, 525 U.S. at 395. Here, the anticompetitive practice is an incumbent's refusal to combine network elements, which the incumbent has the technological capability to combine but which the incumbent has not combined for its own business purposes, when a new entrant requests the combination and agrees to compensate the incumbent to effectuate the combination. Such a practice, like the similar practice addressed by Rule

315(b), typically is engaged in by incumbents "not for any productive reason," *ibid.*, because the new entrant will compensate the incumbent for its costs in combining the network elements. Instead, incumbents engage in the practice "just to impose wasteful * * * costs on new entrants," *ibid.*, because a new entrant would combine the elements itself if it could do so more efficiently, and thus at lower cost, than could the incumbent. A new entrant has no interest in incurring *unnecessary* costs to obtain network element connections.

Thus, Rules 315(c)-(f), like Rule 315(b), are designed to prevent incumbents from erecting barriers to new entrants' access to network element combinations that incumbents themselves would not encounter. The FCC found that incumbent LECs "routinely" create new network element combinations for themselves when it serves their own business purposes to do so. *UNE Remand Order* (para. 481), 15 F.C.C.R. at 3909-3910. That is surely the case, for instance, when incumbents provide their own customers with a "second line" (*e.g.*, for a computer, a home business, or a teen-ager), or when they provide dedicated lines to high-end customers. *Ibid.* Rules 315(c)-(f) prevent incumbents from arbitrarily impeding the ability of new entrants also to provide such combinations. *UNE Remand Order* (paras. 481-482), 15 F.C.C.R. at 3909-3910.[17] Indeed, the FCC has found that the refusal of

---

[17] The FCC has thus far withheld judgment on the question whether Rule 315(b) preserves a new entrant's right to obtain combinations of network elements that are "ordinarily combined" in the incumbent's network, even if the particular facilities at issue are not yet connected. See *UNE Remand Order* (para. 479), 15 F.C.C.R. at 3908-3909.

incumbents to combine network elements sought by new entrants not only is discriminatory, but significantly undermines the utility of the statutory right of prospective competitors to enter the marketplace through the leasing of network elements. See *Local Competition Order* (paras. 293-294), J.A. 295-297; *UNE Remand Order* (paras. 481-482), 15 F.C.C.R. at 3909-3910.

c. To be sure, new entrants may, under the Eighth Circuit's ruling, combine network elements themselves. But that strategy for obtaining combinations may not be available to new entrants in all instances. The FCC has found that "practical difficulties," such as a new entrant's lack of information about the incumbent's network, may "in practice" make it "impossible" for the new entrant to make new combinations of network elements without the incumbent's assistance. *Local Competition Order* (paras. 293-294), J.A. 295-297.

Moreover, even where a new entrant has the technical ability to combine elements itself, the incumbents have imposed other obstacles to the new entrant's doing so. For instance, incumbents often have prohibited new entrants from making connections unless they first purchase collocation space—for which charges can run into the hundreds of thousands of dollars—in the incumbents' central offices. See *UNE Remand Order* (paras. 263, 482), 15 F.C.C.R. at 3815-3816, 3910 (citing *In re Application of BellSouth Corp., et al., for Provision of In-Region, InterLATA Services in Louisiana*, 13 F.C.C.R. 20599, 20703-20705 (1998) (para. 168)).[18] Such restrictions not only are anti-

[18] Verizon has suggested that, in granting Verizon authority to provide long-distance services in New York, the FCC endorsed such restrictions as consistent with Section 251(c)(3). See Verizon Br. in Opp. 21-22 & n.15 (citing *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Sevices in the State of New York*, 15 F.C.C.R. 3953, 4078-4079 (1991) (paras. 231-232)). That contention mischaracterizes the FCC's ruling. Due to the expedited nature of proceedings under Section 271, compliance with the "competitive checklist" prerequisites to Bell company entry into the long-distance market is determined in light of interpretations of the FCC's rules in existence at the time the application is filed. See *AT&T* v. *FCC*, 220 F.3d 607, 631-632 (D.C. Cir. 2000). In the cited order, the FCC noted that its finding that Verizon had satisfied the prerequisites for entry in the long-distance market under 47 U.S.C. 271 was predicated on the Eighth Circuit's decision to vacate Rules 315(c)-(f) and on the view that, "[g]iven this vacuum, * * * it would be inequitable to penalize [Verizon] for complying with the rules established by the New York Commission." 15 F.C.C.R. at 4080 (para. 236) & n.753. That ruling does not constitute an endorsement of the Eighth Circuit's view of Section 251(c)(3) or of the reasonableness of Verizon's conduct in the absence of the Eighth Circuit's decision.

competitive, but also defeat the purpose of some network element combinations, which are designed, at least in part, to avoid the need to purchase collocation space.[19] Such restrictions also undermine the assump-

[19] That would be the case with respect to the so-called "enhanced extended link" (or EEL), which consists of the combination of a local loop and dedicated transport from the loop's end office to another central office. See *UNE Remand Order* (para. 477), 15 F.C.C.R. at 3908. A new entrant with some switches of its own, but without collocation space at each end office, may seek to use this network element combination in order to serve customers whose loops are connected to end offices other than those at which the new entrant has a switch. Incumbents customarily require new entrants first to purchase special access service under tariff in place of the dedicated transport network element, and then to convert to the EEL once the "combination" has thereby been created. *UNE Remand Order* (paras. 480-481), 15 F.C.C.R. at 3909-3910.

tion underlying the Eighth Circuit's invalidation of the combinations rules that incumbents "would rather allow entrants access to their networks than have to rebundle the unbundled elements for them." 120 F.3d at 813.

Other practices of incumbent LECs since the Eighth Circuit vacated Rules 315(c)-(f) further demonstrate the need for those rules as a protection against discrimination. One such practice involves the so-called "UNE platform" (or UNE-P)—the "entire pre-assembled network" that incumbents must provide to new entrants pursuant to Rule 315(b). See *Iowa Utils. Bd. I*, 525 U.S. at 395. To date, the UNE platform has been the most important vehicle for competitive entry into local markets for residential and small business customers, because the UNE platform allows new entrants to lease all of the facilities needed for providing local service to those customers at their forward-looking cost. See *UNE Remand Order* (para. 12), J.A. 15 F.C.C.R. at 3702-3703; Comments of the Competitive Telecommunications Ass'n at 49-51, CC Dkt. No. 96-98, (filed May 26, 1999). Yet, many incumbents, citing the Eighth Circuit's vacatur of Rules 315(c)-(f), are refusing to make the UNE platform available to new entrants, except when the new entrant wins over a customer of the incumbent at the customer's existing location, *i.e.*, where there is an existing combination that falls squarely within the scope of Rule 315(b). Thus, when a customer moves from one location to another, even within the same building, an incumbent may claim that the connection at the new location constitutes a "recombination" outside the scope of Rule 315(b). See, *e.g.*, Comments of the ALTS at 79, CC Dkt. No. 96-98 (filed May 26, 1999). The incumbent may do so even though no new physical connection is required

and the incumbent can activate an existing connection through a few simple computer keystrokes.

In sum, the court of appeals and the incumbent LECs view the 1996 Act as requiring incumbents to share their networks only in narrowly circumscribed ways. Thus, even if combining network elements costs them nothing because they will be fully compensated for the economic cost of doing so, and even if refusing to combine network elements results in the wasteful, inefficient, and discriminatory imposition of costs on competitors, the incumbents assert that the FCC is without authority to require incumbents to combine network elements, because the 1996 Act, while referencing a duty to provide elements in unbundled form, does not expressly reference a duty to combine. But nothing in the text or purpose of the Act suggests that Congress intended a result so contrary to its central purpose of encouraging competition in local telecommunications markets by, *inter alia*, providing new entrants with "nondiscriminatory access" to incumbents' network elements on "reasonable" terms and conditions. 47 U.S.C. 251(c)(3). The FCC's requirement that incumbents perform the combinations sought by new entrants—if the combination is "[t]echnically feasible," 47 C.F.R. 51.315(c), and if the new entrant bears the costs—is "well within the bounds of the reasonable." *Iowa Utils. Bd. I*, 525 U.S. at 395.

CONCLUSION

The decision of the court of appeals should be reversed insofar as it vacated 47 C.F.R. 51.505(b)(1) and 47 C.F.R. 51.315(c)-(f).

Respectfully submitted.

BARBARA D. UNDERWOOD
Acting Solicitor General

JOHN M. NANNES
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

BARBARA MCDOWELL
Assistant to the Solicitor General

CATHERINE G. O'SULLIVAN
NANCY C. GARRISON
Attorneys

JOHN E. INGLE
Deputy Associate General Counsel

LAURENCE N. BOURNE
Counsel
Federal Communications Commission

APRIL 2001

APPENDIX

The parties to the proceeding are as follows:

The petitioners in this Court in No. 00-587 are the United States and the Federal Communications Commission.

The respondents are:

Ad Hoc Telecommunications Users Committee
Airtouch Communications, Inc.
Alabama Public Service Commission
American Communications Services, Inc.
Ameritech Corporation
AT&T Corporation
BellSouth Corp.
California Public Utilities Department
Cincinnati Bell Telephone Company
Citizens Telephone Company of Kecksburg
Comcast Corporation
Concord Telephone Company
Consumers' Utility Counsel Division, Governor's Office of Consumer Affairs
Contel of Minnesota, Inc.
Contel of the South, Inc.
Department of Public Utilities of the Commonwealth of Massachusetts
Excel Telecommunications, Inc.
General Communications, Inc.
GST Telecom, Inc.
GTE Alaska, Inc.
GTE Arkansas, Inc.
GTE Midwest, Inc.
GTE Service Corporation
GTE Southwest, Inc.
ICG Telecom Group, Inc.

Information Technology Industry Council
Iowa Utilities Board
Jones Intercable, Inc.
Kansas Corporation Commission
Kentucky Public Service Commission
KMC Telecom, Inc.
Maryland Public Service Commission
MCI Telecommunications Corporation
Mid-Sized Incumbent Local Exchange Carriers
Mississippi Public Service Commission
National Cable Television Association
National Rural Telecom Association
National Telephone Cooperative Association
New York State Department of Public Service
North Carolina Utilities Commission
North State Telephone Company
Oregon Public Utility Commission
Organization for the Promotion and Advancement of Small Telecommunications Companies
Pennsylvania Public Utility Commission
People of the State of California & PUC of California
Public Utilities Commission of the State of Colorado
Public Service Commission of Wisconsin
Public Service Commission of the State of Montana
Qwest Communications
Rock Hill Telephone Company
Roseville Telephone Company
Rural Telecommunications Group
Rural Telephone Coalition
SBC Communications, Inc.
South Dakota Public Utilities Commission
Sprint Communications Company
Sprint Corporation

Sprint PCS
Sprint Spectrum, L.P.
State of Texas
Telecommunications Resellers Association
Texas Office of Public Utility Counsel
The Ad Hoc Coalition of Telecommunications Manufacturing Companies
The Competition Policy Institute
United States Telecom Association
US Telephone Association
Verizon California, Inc. (formerly GTE California, Inc.)
Verizon Communications, Inc. (formerly Bell Atlantic Corp.)
Verizon Florida, Inc. (formerly GTE Florida, Inc.)
Verizon Hawaii Int'l, Inc. (formerly GTE Hawaiian Tel. Co., Inc.)
Verizon North, Inc. (formerly GTE North, Inc.)
Verizon Northwest, Inc. (formerly GTE Northwest, Inc.)
Verizon South, Inc. (formerly GTE South, Inc.)
Verizon West Coast, Inc. (formerly GTE West Coast, Inc.)
Virginia State Corporation Commission
Winstar Communications

(5) (6) (5) (6) (6)

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
APR 9 2001
CLERK

IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Respondents.

APR 9 2001

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF ON THE MERITS OF SPRINT CORPORATION IN SUPPORT OF PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

BEST AVAILABLE COPY

WASHINGTON, D. C. 20001

35 pp

QUESTIONS PRESENTED

1. Whether the court of appeals erred in holding that Section 252(d)(1) of the Act forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies.

2. Whether Section 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

RULE 29.6 STATEMENT

In accordance with Rule 29.6 of the Rules of this Court, Sprint Corporation ("Sprint") states as follows:

Sprint is a corporation organized for the purpose of engaging in telecommunications and related businesses and is publicly traded under the names Sprint FON and Sprint PCS. Sprint Communications Company L.P. is a wholly-owned subsidiary of Sprint. Deutsche Telekom and France Télécom, both of which have issued public stock, each own approximately a ten percent share of Sprint.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
PRELIMINARY STATEMENT	1
OPINIONS AND ORDERS BELOW	2
STATEMENT OF THE CASE	2
A. Background	2
B. The Act.	3
C. FCC Regulations.	4
1. Pricing Rules.	5
2. Network Combinations Rule	6
D. Judicial Review of the *Local Competition Order*.	7
1. The First Eighth Circuit Decision.	7
2. *IUB I*	8
3. The Eighth Circuit's Decision On Remand ("*IUB II*").	9
SUMMARY OF ARGUMENT	10
ARGUMENT	12
I. A COST METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST OF EXISTING TECHNOLOGY DOES NOT VIOLATE THE ACT.	13
A. Congress Did Not Foreclose A Cost Methodology Based On The Efficient Replacement Cost Of Existing Technology.	13

TABLE OF CONTENTS—Continued

	Page
B. The FCC's Efficient Network Configuration Rule Was Reasonable And Entitled To Deference.	17
C. The Eighth Circuit's Holding Is Internally Inconsistent, Economically Unsound, And Will Lead To Unintended Results That Thwart Congress' Goal Of Facilitating Competition.	20
II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS SERVES THE PRO-COMPETITIVE PURPOSES OF THE ACT AND DOES NOT VIOLATE THE LANGUAGE OF SECTION 251(c)(3).	21
A. This Court Has Previously Held That Section 251(c)(3) Is Ambiguous.	21
B. The Eighth Circuit Has Erred A Second Time In Holding That Section 251(c)(3) Unambiguously Requires New Entrants To Combine UNEs.	24
C. It Was Reasonable For the FCC To Promulgate A Regulation That Prevents ILECs From Engaging In An "Anticompetitive Practice."	25
CONCLUSION	27

TABLE OF AUTHORITIES

CASES	Page
AT&T Corp. v. FCC, 220 F.3d 607 (D.C. Cir. 2000)	16
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	12
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	21
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	7, 22
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	*passim*
MCI Telecomms. Corp. v. U S W. Communications, Inc., 204 F.3d 1262 (9th Cir.), *cert. denied*, 121 S. Ct. 504 (2000)	23
Market St. Ry. Co. v. Railroad Comm'n of Cal., 324 U.S. 548 (1945)	16
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	16
Regions Hosp. v. Shalala, 522 U.S. 448 (1998)	12, 13
Southwestern Bell Tel. Co. v. Waller Creek Communications, Inc., 221 F.3d 812 (5th Cir. 2000)	23
Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000)	5
U S W. Communications, Inc. v. Hix, Civ. No. 97-D-152 (consol.), Order (D. Colo. June 26, 2000)	23

TABLE OF AUTHORITIES—Continued

	Page
U S W. Communications, Inc. v. MFS Intelenet, Inc., 193 F.3d 1112 (9th Cir. 1999), *cert. denied*, 120 S. Ct. 2741, *reh'g denied*, 121 S. Ct. 18 (2000)	23
AGENCY DECISIONS	
In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996)	*passim*
In re Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, 15 F.C.C.R. 3696 (1999)	26
STATUTES	
47 U.S.C. § 153(29)	16
47 U.S.C. § 201(b)	4
47 U.S.C. § 251(c)(2)-(4)	4
47 U.S.C. § 251(c)(3)	*passim*
47 U.S.C. § 251(d)(1)	4
47 U.S.C. § 252(d)(1)	*passim*
47 U.S.C. § 252(d)(1)(A)-(B)	14
47 U.S.C. § 252(d)(1)(A)(i)	4
47 U.S.C. § 252(d)(1)(B)	4
REGULATIONS	
47 C.F.R. § 51.315	6
47 C.F.R. § 51.315(b)	*passim*
47 C.F.R. § 51.315(c)	*passim*
47 C.F.R. § 51.315(c)-(f)	*passim*
47 C.F.R. § 51.505(b)(1)	*passim*
47 C.F.R. § 51.505(b)(2)	6
47 C.F.R. § 51.505(b)(3)	6
47 C.F.R. § 51.505(c)	6

TABLE OF AUTHORITIES—Continued

CONGRESSIONAL MATERIAL	Page
H.R. Conf. Rep. No. 104-230 (1996)	3, 4
OTHER AUTHORITY	
Paul W. Garnett, *Forward-Looking Costing Methodologies and the Supreme Court's Takings Clause Jurisprudence*, 7 CommLaw Conspectus 119 (1999)	7

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.2 and 25.1, Respondent Sprint Corporation ("Sprint") respectfully submits this Brief on the Merits of Sprint Corporation in Support of Petitioners Federal Communications Commission ("FCC") and United States of America. This brief addresses the following questions:

- Whether the court of appeals erred in holding that 47 U.S.C. § 252(d)(1) (Telecommunications Act of 1996) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies.

- Whether 47 U.S.C. § 252(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

Supreme Court Order List (Jan. 22, 2001) at 3-4.[1]

---

[1] The Court also granted the petitions for a writ of certiorari with respect to the following question presented by Verizon Communications, Inc. and the other incumbent local exchange carriers: "Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's 'historical' costs into the rates that it may charge new entrants for access to its network elements." Sprint supports the decision of the court of appeals upholding the FCC's regulations and will file a Respondent's Brief On The Merits, in accordance with the briefing schedule ordered by the Court.

OPINIONS AND ORDERS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 219 F.3d 744 and reprinted in the Petition for a Writ of Certiorari of the FCC and United States of America at 1a-43a.[2] This decision reviewed the First Report and Order, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (Aug. 8, 1996) ("*Local Competition Order*"), and accompanying regulations issued by the FCC. The *Local Competition Order* is reported at 11 F.C.C.R. 15,499. Relevant portions of the *Local Competition Order* are reprinted at FCC Pet. App. 44a-103a. The regulations are codified at 47 C.F.R. §§ 51.1-51.809. Relevant portions of the codified regulations are reprinted at FCC Pet. App. 126a-131a. The *Local Competition Order* and codified regulations implemented the Telecommunications Act of 1996 ("Act"), Pub. L. No. 104-104, 110 Stat. 56 (codified at 47 U.S.C. §§ 151-276). Relevant portions of the Act are reprinted at FCC Pet. App. 104a-125a.

STATEMENT OF THE CASE

A. Background.

Unlike many of the private parties participating in these proceedings, Sprint has *both* local and long distance operations. The "long distance side" of Sprint, like other new entrants, is interested in obtaining nondiscriminatory access to the networks of the incumbent local exchange carrier ("incumbent LEC" or "ILEC") at rates that will facilitate Sprint's ability to compete for business in the local telephone markets. The "local side" of Sprint, like other ILECs, is interested in ensuring that its rights and obligations under the

[2] The Court has agreed to the submission of a deferred Joint Appendix. For purposes of this brief, Sprint cites to previously reproduced excerpts from the Petition for a Writ of Certiorari of the FCC and United States of America ("FCC Pet. App. _").

Act are rationally and uniformly elucidated, that it is fairly compensated for sharing its local networks with new entrants, and that its operations are not unduly burdened. Sprint has participated both as a new entrant and as an ILEC in state-regulated arbitrations pursuant to Section 252 of the Act. These experiences have given Sprint a balanced perspective on the challenges of opening local telephone markets to competition while satisfying the divergent interests of new entrants and ILECs.

Sprint believes that the vacated FCC regulations strike the proper balance in implementing the Act's pro-competitive objectives. The vacated price regulation establishes a forward-looking, long-run methodology for pricing unbundled network elements ("UNEs") based on "the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." 47 C.F.R. § 51.505(b)(1) ("Rule 505(b)(1)") (FCC Pet. App. 128a). This methodology attempts to replicate prices that would prevail in a competitive environment while ensuring that the ILEC is compensated for the use of its network elements at prices reflecting what it would cost to replace the elements today. The vacated network combinations regulation requires that ILECs "perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network." *Id.* § 51.315(c) ("Rule 315(c)") (FCC Pet. App. 126a). This requirement is intended to ensure that new entrants have efficient and meaningful access to UNEs in order to offer competitive local services.

B. The Act.

The Act seeks to transform state-sanctioned local monopolies into fully competitive markets on a national scale. *See* H.R. Conf. Rep. No. 104-230, at 113 (1996) (the primary goal of the Act is to increase competition in both

local and long distance telephone markets as swiftly as possible). Congress recognized the practical and economic impediments that new entrants would face if forced to replicate all of the ILEC's existing local network infrastructure. Congress therefore established comprehensive requirements "intended to facilitate market entry." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999) ("*IUB I*"). "Foremost" among them is the ILEC's "obligation under [Section 251(c)] to share its network with competitors." *Id.* The Act provides three complementary avenues for new entrants to obtain access to an ILEC's network: (i) interconnection with an ILEC's existing local network; (ii) leasing UNEs of the ILEC's network, either alone or in combination; and (iii) reselling the ILEC's services. 47 U.S.C. § 251(c)(2)-(4) (FCC Pet. App. 106a-107a).

Section 251(c)(3), which is at issue here, imposes a duty on ILECs to provide "nondiscriminatory" access to UNEs. *Id.* § 251(c)(3) (FCC Pet. App. 106a-107a). New entrants may use the leased UNEs, alone or in combination with the new entrant's own network facilities, to offer new and different competitive local services. ILECs are to receive "just [and] reasonable" compensation for leasing UNEs, "based on the cost . . . of providing" the element, including a "reasonable profit." *Id.* §§ 251(c)(3), 252(d)(1)(A)(i), (B) (FCC Pet. App. 106a-107a, 119a).

C. FCC Regulations.

Congress expressly delegated to the FCC the authority to promulgate rules to implement the Act's requirements. *Id.* §§ 201(b), 251(d)(1) (FCC Pet. App. 108a). The Act sets few limits on the FCC's exercise of this authority. As this Court has recognized, the key provisions of the Act are subject to multiple interpretations and Congress was "well aware" that these ambiguities would be resolved by the FCC. *IUB I*, 525 U.S. at 397. The FCC adopted its local competition rules on

August 8, 1996. *Local Competition Order*, 11 F.C.C.R. at 15,499.

1. Pricing Rules.

The FCC promulgated a cost methodology for establishing UNE rates that attempts to replicate conditions in a competitive market, while fairly compensating ILECs for the "cost" of providing the UNE. The FCC concluded that a "forward-looking long-run economic cost" approach would best accomplish these objectives. *Id.* at 15,844 (¶ 672) (FCC Pet. App. 61a-62a). A forward-looking approach measures the cost today to build an efficient local network with the same capabilities. *Id.* at 15,857-58 (¶ 705) (FCC Pet. App. 86a-87a). New entrants, which build new facilities using the lowest cost, most efficient technology available, set prices on that basis. In response to this competition, ILECs, likewise would replace existing facilities using the lowest cost, most efficient technology available.

Forward-looking cost methods have been widely accepted in the professional literature, were implemented by several state utility commissions prior to passage of the Act, *see id.* at 15,817-19 & nn.1508-14 (¶ 631) (FCC Pet. App. 56a-58a), and were used by numerous other regulatory agencies in analogous contexts, *see Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12 & 13 (5th Cir. 1999) (citing examples of agencies adopting forward-looking, most efficient technology methodologies to encourage competition), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000). The particular forward-looking approach adopted by the FCC is called "Total Element Long Run Incremental Cost" or "TELRIC." TELRIC ensures that ILECs recover the full forward-looking cost of leased UNEs by measuring the long-run, incremental cost of the network element based on: (i) the use of the "most efficient telecommunications technology currently available and the lowest cost network configuration,

given the existing location of the incumbent LEC's wire centers," 47 C.F.R. § 51.505(b)(1) (FCC Pet. App. 128a); (ii) the cost of capital, thus allowing ILECs to recover normal economic profit, *id.* § 51.505(b)(2) (FCC Pet. App. 128a); and (iii) the useful life of the element, as measured by its economic depreciation rate, *id.* § 51.505(b)(3) (FCC Pet. App. 128a). In addition, TELRIC allows for a reasonable share of joint and common costs. *Id.* § 51.505(c) (FCC Pet. App. 129a).

2. Network Combinations Rule.

The FCC promulgated a network combinations rule to implement the requirement in Section 251(c)(3) that ILECs provide nondiscriminatory access to UNEs in a manner that allows new entrants to use those elements to offer competitive local services to customers. *Id.* § 51.315 (FCC Pet. App. 126a-127a). The network combinations rule establishes two related requirements. 47 C.F.R. § 51.315(b) ("Rule 315(b)") prohibits the ILEC from separating elements already combined in its network. Rule 315(c) requires the ILEC to combine, at a new entrant's request, elements that are not already combined to the extent technically feasible. The FCC determined that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent." *Local Competition Order*, 11 F.C.C.R. at 15,647 (¶ 293) (FCC Pet. App. 45a). The FCC found that as a result of these "practical difficulties," requesting carriers "would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets," if ILECs were not required to combine UNEs upon request. *Id.* (¶¶ 293-294) (FCC Pet. App. 45a-46a).

D. Judicial Review of the *Local Competition Order*.

1. The First Eighth Circuit Decision.

Challenges to the *Local Competition Order* were consolidated in the Eighth Circuit and first decided in 1997. Of relevance here, the Eighth Circuit invalidated the FCC's pricing rules—including Rule 505(b)(1)—holding that the Act gives state public utility commissions, not the FCC, general jurisdiction to interpret and implement the Act's pricing provisions. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 794-800 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999).[3] The Eighth Circuit also invalidated Rule 315(b)-(f)—the network combinations rule—on the ground that it violated the plain terms of Section 251(c)(3) of the Act. *Id.* at 813. According to the Eighth Circuit, "Section 251(c)(3) requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis." *Id.* The Eighth Circuit believed that the statute "*unambiguously* indicates that requesting carriers will combine the unbundled elements themselves" because "the Act requires incumbent LECs to provide elements in a manner that enables the competing carriers to combine them." *Id.* (emphasis added). The Eighth Circuit thus rejected the FCC's interpretation of Section 251(c)(3), holding that the statutory "language [cannot] be read to levy a duty on the incumbent LECs to do the actual combining of elements." *Id.*

---

[3] During the period when the FCC's pricing rules were vacated on jurisdictional grounds, the overwhelming majority of state commissions independently chose to adopt the TELRIC methodology. *See* Paul W. Garnett, *Forward-Looking Costing Methodologies and the Supreme Court's Takings Clause Jurisprudence*, 7 CommLaw Conspectus 119, 132 (1999) (at least 35 states announced their intent to adopt TELRIC).

2. *IUB I.*

In *IUB I*, this Court described the paramount role Congress gave the FCC to interpret and implement the Act and the limited circumstances under which federal courts may override the decisions of the FCC. The Court stated as follows:

> It would be gross understatement to say that the Telecommunications Act of 1996 is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. . . . The 1996 Act can be read to grant . . . "most promiscuous rights" to the FCC vis-à-vis the state commissions and to competing carriers vis-à-vis the incumbents—and the [FCC] has chosen in some instances to read it that way. But Congress is well aware that *the ambiguities it chooses to produce in a statute will be resolved by the implementing agency*. (citation omitted). We can only enforce the *clear limits* that the 1996 Act contains . . . .

IUB I, 525 U.S. at 397 (emphasis added).

This Court reversed numerous parts of the Eighth Circuit's decision. Among other things, the Court held that Section 201(b) of the Act gives the FCC jurisdiction to adopt rules to implement all of the Act's local competition provisions. *Id.* at 377-86. The Court reversed the Eighth Circuit's ruling that the FCC lacked the statutory authority to establish national pricing rules, reinstated the FCC's pricing rules, and remanded so that the Eighth Circuit could review the substantive challenges to those rules. *Id.* at 377-78.

This Court also addressed one aspect of the FCC's network combinations rule, Rule 315(b), which prohibits ILECs from separating requested network elements that the ILEC ordinarily combines. The Court rejected the Eighth Circuit's "plain language" argument, holding that Section 251(c)(3) is ambiguous. *Id.* at 395. The Court held that the term "unbundled" in Section 251(c)(3) could refer to separately

priced assets as distinguished from "physically separated" assets. *Id.* at 394. Although the Act contemplates that elements may be requested and provided in discrete pieces, the Court held that the Act "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *Id.* (emphasis in original). The Court further found Rule 315(b) to be "entirely rational, finding its basis in § 251(c)(3)'s nondiscrimination requirement." *Id.* at 395. The Court accepted the FCC's explanation that the only reason an ILEC would disconnect previously connected elements over the objection of the new entrant would be to impose wasteful reconnection costs. The Court held that "[i]t is well within the bounds of the reasonable for the [FCC] to opt in favor of ensuring against an anticompetitive practice." *Id.*

3. The Eighth Circuit's Decision On Remand ("*IUB II*").

In July 2000, the Eighth Circuit issued its decision on remand. The Eighth Circuit found that the term "cost" in § 252(d)(1) is "ambiguous" and that the FCC was therefore authorized to interpret the term to allow for a forward-looking cost model. *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 751-52 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 11a). The Eighth Circuit further held that the FCC's "use of a forward-looking cost methodology was reasonable," noting that the FCC had explained its reasoning "in detail." *Id.* at 752 (FCC Pet. App. 12a).[4]

---

[4] The court also held that the doctrine of constitutional avoidance did not require the FCC to use a historical cost model, citing well established law that "a takings claims cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *IUB II*, 219 F.3d at 754 (FCC Pet. App. 17a). The court thus rejected as premature the incumbents' Takings Clause challenge to the TELRIC methodology. *Id.* (FCC Pet. App. 17a-18a)

Despite affirming the use of a forward-looking price methodology, the Eighth Circuit invalidated a key component of the FCC's methodology that measures forward-looking costs "based on the use of the most efficient tele-communications technology currently available and the lowest cost network configuration." *Id.* at 749-50 (FCC Pet. App. 8a). The Eighth Circuit held that because Section 252(d)(1) states that an ILEC may charge a just and reasonable rate "based on the cost . . . of providing *the* . . . network element," Rule 505(b)(1) is contrary to "the plain meaning" of the statute. *Id.* at 750 (FCC Pet. App. 8a) (emphasis in original). According to the Eighth Circuit, Congress' use of the definite article "the" in Section 252(d)(1) necessarily refers to the actual facilities deployed by the ILEC and thus precludes a forward-looking methodology that calculates costs by reference to the most efficient technology and design choices. *Id.*

The Eighth Circuit also reaffirmed its prior invalidation of Rule 315(c)-(f), notwithstanding this Court's reinstatement of Rule 315(b). *Id.* at 759 (FCC Pet. App. 27a). The Eighth Circuit again held that Congress, in the second sentence of Section 251(c)(3), "has directly spoken on the issue of who shall combine previously uncombined network elements. It is the requesting carriers who shall 'combine such elements.'" *Id.* (FCC Pet. App. 28a-29a).

SUMMARY OF ARGUMENT

In *IUB I*, this Court noted that the Act is in many respects ambiguous and held that the FCC is entitled to deference in interpreting and implementing its local competition provisions. The Eighth Circuit on remand refused to accord such deference to the FCC's determinations that forward-looking costs should be measured based upon a "least cost, most efficient technology" (Rule 505(b)(1)), and that ILECs should be required to combine network elements not ordinarily combined in their networks upon request (Rule

315(c)-(f)). The Eighth Circuit reasoned that both challenged regulations violated the "plain meaning" of the Act. These holdings rest on overly restrictive readings of the Act that will thwart, rather than promote, local telephone competition.

Rule 505(b)(1)'s "efficient network configuration" requirement helps to ensure that prices for UNEs are set at rates that replicate a competitive market, compensating the ILEC for what it would cost to replace the elements in today's market. As an organization with both long distance and local operations, Sprint believes that Rule 505(b)(1) strikes a fair and reasonable balance and is consistent with the pro-competitive purposes of the Act. The Eighth Circuit erroneously believed the statutory language in Section 252 (d)(1) requiring that UNE rates be based on the cost of providing "the" interconnection or network element unambiguously means that rates may only be based on the cost of the ILEC's existing network. This holding compensates ILECs based on the cost of replacing network equipment with the very same equipment, even if no rational firm would deploy such technology in a competitive marketplace. Such an outcome is unsatisfactory to Sprint's entire organization. If costs are set too high, it will preclude effective competition. If costs are set too low, it will send false signals to potential new entrants concerning efficient entry levels. Rule 505(b)(1) helps to avoid these adverse results by setting costs in a manner that most closely simulates those of a competitive market.

Rule 315(c)-(f)'s combinations requirement ensures that new entrants will have nondiscriminatory access to UNEs in a manner that permits them to provide competitive services. The Eighth Circuit erroneously believed that the statutory language "unambiguously" requires new entrants to "do the combining themselves." This Court has already rejected that interpretation of Section 251(c)(3), which, as the FCC found, would effectively preclude many new entrants from using UNEs to offer competitive services. Because an ILEC

maintains control over its own network, it typically would be more efficient and less costly for the ILEC to perform the functions necessary to combine UNEs. In some instances, it may be practically impossible for a new entrant to combine UNEs located within the network of the ILEC. Under the FCC's rule, the ILEC would be compensated at cost-based rates for performing the functions necessary to combine the elements. Sprint knows of no reason why an ILEC would refuse to do so other than to impose unnecessary burdens and costs on the new entrant.

The Act is designed to benefit consumers by bringing rapid competition to local telephone services. The regulations vacated by the Eighth Circuit are rational measures that the FCC deemed necessary to carry out Congress' mandate. The regulations should be restored.

ARGUMENT

This Court's review of the challenged FCC regulations should be highly deferential. Under the relevant standard, the FCC's implementing regulations should be upheld unless "Congress has . . . addressed the precise question at issue" and unambiguously foreclosed the FCC's choice, or the agency's reasoning was arbitrary. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43, 845 (1984) ("*Chevron*"); *IUB I*, 525 U.S. at 397 (pursuant to *Chevron*, courts are only to "enforce the clear limits that the [Telecommunications Act of 1996] contains"). In making these determinations, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *Chevron*, 467 U.S. at 844. "If the agency's reading [of a statute] fills a gap or defines a term in a reasonable way in light of the Legislature's design, we give that reading controlling weight, even if it is not the answer 'the court would have reached if the question initially had arisen in a judicial proceeding.'"

Regions Hosp. v. Shalala, 522 U.S. 448, 457 (1998) (quoting *Chevron*, 467 U.S. at 843 n.11).

The Act, as this Court noted, "is in many important respects a model of ambiguity or indeed even self-contradiction" that imposes few restraints on the FCC's exercise of its implementing authority. *See IUB I*, 525 U.S. at 397 (the Act grants "most promiscuous rights" to the FCC); *see also id.* ("Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency."). The Eighth Circuit acknowledged that the Act contained ambiguities and that the responsibility for resolving them belongs to the FCC, not the courts. *IUB II*, 219 F.3d at 752 (FCC Pet. App. 11a-12a). Even so, the Eighth Circuit invalidated the pricing and network combinations rules based on strained readings of the "plain language" of the statute, thereby improperly depriving the expert agency of its authority to implement the Act's objectives.

I. A COST METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST OF EXISTING TECHNOLOGY DOES NOT VIOLATE THE ACT.

A. Congress Did Not Foreclose A Cost Methodology Based On The Efficient Replacement Cost Of Existing Technology.

The Eighth Circuit recognized that "the term 'cost,' as it is used in [Section 252(d)(1)], is ambiguous and that Congress has not spoken directly on the meaning of the word in this context." *Id.* at 751 (FCC Pet. App. 11a). The Eighth Circuit thus held that "the FCC's use of a forward-looking cost methodology was reasonable," noting that in the *Local Competition Order*, "the FCC explained in detail its reason for selecting a forward-looking cost methodology to implement the new competitive goals of the Act." *Id.* at 752 (FCC Pet. App. 12a).

Despite correctly holding that Section 252(d)(1) is ambiguous with respect to what is meant by "cost," the Eighth Circuit erroneously concluded that Section 252(d)(1) *unambiguously* precludes the FCC from adopting a methodology that measures that cost by reference to an efficient network. "It is clear from the language of the statute," the court held, "that Congress intended the rates to be 'based on the cost . . . of providing *the* interconnection or network element' . . . not the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished." *Id.* at 750 (FCC Pet. App. 8a-9a) (emphasis in original). The court then detailed its understanding of what the Act mandates: "The new entrant competitor, in effect, piggybacks on the ILEC's existing facilities and equipment. It is the cost to the ILEC of providing that ride on those facilities that the statute permits the ILEC to recoup." *Id.* at 751 (FCC Pet. App. 9a). Accordingly, the Eighth Circuit concluded, Section 252(d)(1) requires that rates be calculated based on the forward-looking cost of the ILEC's *existing* network.

The Eighth Circuit misinterpreted Section 252(d)(1). The provision states, in pertinent part, that "the just and reasonable rate for the interconnection of facilities and equipment . . . and the just and reasonable rate for network elements" be based on the cost "of providing *the interconnection or network element* (whichever is applicable), and [] nondiscriminatory, and [] may include a reasonable profit." 47 U.S.C. § 252(d)(1)(A)-(B) (FCC Pet. App. 118a-119a) (emphasis added). The use of "the" before the phrase "interconnection or network element" merely identifies the thing (interconnection or network element) to which the cost-based requirement applies. "The" does not carry—and should not be read necessarily to imply—some greater connotation that unambiguously limits the FCC's ability to

determine a basic component of its methodology for determining UNE "cost."

A cost methodology based on the most efficient replacement cost of existing network elements comports with the Eighth Circuit's conclusion that Section 252(d)(1) mandates that rates be based on the cost of providing the actual network element used by a new entrant. A long-run methodology assumes a period long enough that all costs are variable. That is to say, the very nature of such a methodology assumes that all plant and equipment can be replaced. If all plant and equipment can be replaced, any rational firm would do so in the most efficient manner. The long-term, forward-looking cost of the original piece of equipment is the cost of the efficient, new equipment needed to replace it.

Rule 505(b)(1) thus correctly measures the cost of providing the actual network element or interconnection by asking what cost the ILEC or any other carrier would bear in the marketplace *today* to replace the functions at issue with efficient substitutes currently available on the market that could be used consistently with the location of the ILEC's existing wire centers. Although the Eighth Circuit agreed that Section 252(d)(1) could be reasonably interpreted to permit a forward-looking cost methodology, the court's strained emphasis on the word "the" in the provision precludes a key component that gives rational effect to that methodology. Given that the Act's pricing provisions "give rate-setting commissions broad methodological leeway; [and] say little about the 'method employed' to determine a particular rate," *see IUB I*, 525 U.S. at 423 (Breyer, J., dissenting in part), the FCC's use of the most efficient replacement cost in Rule 505(b)(1), as a component of its TELRIC methodology, should be given controlling weight.

The Eighth Circuit misconstrued the statutory language in another respect as well. The Eighth Circuit incorrectly presumed that, in considering the costs of efficient

substitutes, regulators are determining the forward-looking cost of something other than the elements whose functions the new entrant seeks to obtain. The forward-looking cost of any asset necessarily turns on the cost of replacing its *functions* with currently available, efficient substitutes. The term "element" describes, at an appropriately high level of generality, the *class* of facilities (or "features, functions, and capabilities") associated with particular tasks within the network. 47 U.S.C. § 153(29); *IUB I*, 525 U.S. at 387. For example, fiber wires and copper wires, despite their technological differences, can both be used to provide the loop element. *Cf. AT&T Corp. v. FCC*, 220 F.3d 607, 618-19 (D.C. Cir. 2000) (reviewing relative merits of using optical fiber versus copper to determine forward-looking cost of loop element). Similarly, analog switches and digital switches can both be used to provide the switching element. *Local Competition Order*, 11 F.C.C.R. at 15,691, 15,706 (¶¶ 380, 412). The Eighth Circuit's decision confines the term "element" to individual pieces of equipment. Consequently, the Eighth Circuit believed that the forward-looking inquiry should turn on the cost of replacing an ILEC's existing facilities in every physical particular—rather than the *function* of those facilities—regardless of whether a rational actor would construct such facilities in today's market. Nothing in the language of Section 252(d)(1) remotely compels the adoption of that long-discredited methodological approach. *Id.* at 15,848 (¶ 684) (FCC Pet. App. 70a) (recognizing that such an approach could produce rates "that reflect inefficient or obsolete network design and technology"); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment) (disparaging, as the *least* appropriate cost methodology, an inquiry into "what it would cost to reproduce the identical property"); *Market St. Ry. Co. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 567 (1945) (in rate-setting contexts it never has been held that state

commissions must "fix rates on the present reproduction value of something no one would presently want to reproduce").

B. The FCC's Efficient Network Configuration Rule Was Reasonable And Entitled To Deference.

The FCC adopted TELRIC because, in its view, a methodology based on forward-looking economic costs should "drive retail prices to their competitive levels" by setting costs at levels firms would face in a competitive market. *Local Competition Order*, 11 F.C.C.R. at 15,846 (¶ 679) (FCC Pet. App. 66a). This "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." *Id.* at 15,817 (¶ 630) (FCC Pet. App. 55a). The FCC carefully evaluated alternatives to its TELRIC methodology, as well as more general objections to the use of forward-looking pricing. The FCC also considered several variants of forward-looking pricing before determining that TELRIC is the most effective and fair means to implement the Act's pro-competitive goals.

In particular, the FCC rejected pricing based on the "historical" or "embedded" costs reflected on the ILECs' accounting books. The FCC recognized that these costs could be either higher or lower than forward-looking costs. *Id.* at 15,857-58 (¶ 705) (FCC Pet. App. 86a-87a). The FCC reasoned that the use of historical costs in determining the rates paid by new entrants would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the [] Act." *Id.* at 15,858 (¶ 705) (FCC Pet. App. 87a). The FCC thus concluded that historical cost pricing would frustrate the Act's competitive objectives. *Id.* at 15,857-60 (¶¶ 704-711) (FCC Pet. App. 84a-91a).

The FCC likewise declined to establish a formula that would estimate the "forward-looking" cost of the ILEC's existing network. *Id.* at 15,848 (¶ 684) (FCC Pet. App. 70a). This approach appears to most closely resemble the Eighth Circuit's decision. Because this approach would allow ILECs to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* In asking what it would cost to replace the functions that make an asset valuable, the FCC noted that a forward-looking methodology requires an inquiry into currently available substitutes—including assets that perform the same functions as the original asset, but that do not resemble the asset in all respects—because they embody more efficient technology than does the original asset. *Id.* at 15,848-49 (¶¶ 683-685) (FCC Pet. App. 69a-71a).

The FCC did not, as the Eighth Circuit wrongly contends, base its TELRIC methodology on "some state of the art presently available technology ideally configured but neither deployed by the ILEC nor to be used by the competitor." *See IUB II*, 219 F.3d at 751 (FCC Pet. App. 10a). The FCC noted that "[p]rices based on the least-cost, most efficient network design and technology replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represent the least-cost systems available for purchase . . . ." *Local Competition Order*, 11 F.C.C.R. at 15,848 (¶ 683) (FCC Pet. App. 69a). Even so, the FCC expressly declined to adopt a forward-looking methodology "based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry." *Id.* The FCC instead established a methodology "based on costs similar to those incurred by incumbents." *Id.* at 15,846 (¶ 679) (FCC Pet. App. 66a-67a). The FCC accomplished this by determining that TELRIC should take as given the ILEC's existing wire centers. *Id.* at

15,848-49 (¶ 685) (FCC Pet. App. 70a-71a). That pragmatic limitation has considerable significance for determining the rates that ILECs may charge, because it confines the inquiry to efficient alternatives that are compatible with the most basic geographic design of the existing network. By basing prices on efficient new technology that is compatible with the ILEC's actual wire center locations, the FCC's approach mitigates ILECs' concerns that a forward-looking pricing methodology ignores their existing infrastructure. In the FCC's words, "[t]his benchmark of forward-looking cost and existing network design *most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants*." *Id.* at 15,849 (¶ 685) (FCC Pet. App. 70a-71a) (emphasis added). The FCC further determined that this limitation, by encouraging new entrants to reduce costs "by designing more efficient network configurations," would put to rest any concern that the use of a forward-looking cost methodology would leave new entrants with insufficient incentives to construct their own facilities. *Id.* (FCC Pet. App. 71a).

TELRIC thus encourages and facilitates efficient market entry. If the rates for network elements are set below forward-looking cost, new entrants might be deterred from building competing facilities. Moreover, some new entrants would be induced to enter using network elements where it would not otherwise be economically efficient for them to do so. If the rates for network elements are set too high, however, competitive entry may never occur. That is because it is unlikely that new entrants will ever build completely ubiquitous local networks and consequently must rely, at least in part, on leased elements. Because new entrants would be unable to price their retail services at competitive levels, they would decline to enter the market at all. By designing a forward-looking cost methodology that simulates a competitive market, the FCC sought to ensure that the rates eventually produced by that methodology would encourage

new entrants to build competing facilities without stifling competition from the outset. *Id.* at 15,848-49 (¶ 685) (FCC Pet. App. 70a-71a). Rule 505(b)(1)'s network configuration requirement is a reasonable and necessary component of that methodology. The Rule should be reinstated under *Chevron*.

C. The Eighth Circuit's Holding Is Internally Inconsistent, Economically Unsound, And Will Lead To Unintended Results That Thwart Congress' Goal Of Facilitating Competition.

Contrary to the Eighth Circuit's suggestion, the more appropriate way to "deal[] with reality" in determining the forward-looking costs of network elements is to take current available alternatives into account, rather than ignore them. In competitive markets, the price that a firm would pay to lease particular facilities varies with the cost of obtaining the function of the facilities through some other means, including through the use of more efficient substitutes. A firm would not arbitrarily blind itself to the availability of such substitutes. Taking those substitutes fully into account is not "fantasizing about what might be," as the Eighth Circuit wrongly believed, but is a routine part of any sensible inquiry into the current value of an asset. Indeed, it would be irrational, in conducting such an inquiry, to *omit* consideration of the effective substitutes altogether and to proceed on the assumption that technology has frozen in time and has no bearing on replacement costs.

Moreover, the Eighth Circuit's holding undermines Congress' goal of creating competitive market conditions as quickly as possible—a goal the Eighth Circuit itself recognized was advanced by a forward-looking cost methodology. If new competitors could enter the local market immediately by building ubiquitous networks, they would set prices based on forward-looking costs using the latest and most efficient technologies, and ILECs would be forced to follow suit. TELRIC achieves a similar result in the

short term by allowing new entrants to lease parts of the existing network at their competitive market value. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) (forward-looking costs "mimic[] the operation of the competitive market"). The FCC's approach encourages the "*efficient* entry and utilization of the telecommunications infrastructure," *Local Competition Order*, 11 F.C.C.R. at 15,817 (¶ 630) (FCC Pet. App. 55a) (emphasis added), while sending the correct signals for entry, investment and innovation to producers, investors and consumers. By contrast, the Eighth Circuit's decision, which results in a cost methodology that attempts to calculate the cost to reproduce the identical equipment in the ILEC's network at today's cost, even if such a network would never be built today because the technology deployed is obsolete and inefficient, is essentially an embedded cost methodology.

Finally, the Eighth Circuit's holding could lead to unexpected results. The court's conclusion that "it is the cost to the ILEC of carrying the extra burden of the competitor's traffic that Congress entitled the ILECs to recover" suggests that the Act mandates a pure incremental cost methodology. This approach could result in a sweeping downward departure from the prices arrived at under TELRIC, providing inadequate compensation to ILECs and artificial incentives for new entrants to compete solely by leasing UNEs instead of establishing their own networks.

II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS SERVES THE PRO-COMPETITIVE PURPOSES OF THE ACT AND DOES NOT VIOLATE THE LANGUAGE OF SECTION 251(c)(3).

A. This Court Has Previously Held That Section 251(c)(3) Is Ambiguous.

Section 251(c)(3) imposes on ILECs:

> The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis .... An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

47 U.S.C. § 251(c)(3) (FCC Pet. App. 106a-107a).

To implement this statutory provision, the FCC promulgated regulations that prohibited ILECs from separating already combined network elements requested by new entrants, 47 C.F.R. § 51.315(b) (FCC Pet. App. 126a), and that required ILECs to combine network elements that are not "ordinarily combined in the incumbent's network at a new entrant's request," *see id.* § 51.315(c)-(f) (FCC Pet. App. 126a-127a). The first time the Eighth Circuit reviewed the FCC's network combinations rule, it held that Section 251(c)(3) "requires an incumbent LEC to provide access to the elements of its network *only* on an unbundled (as opposed to a combined) basis" and "*unambiguously* indicates that requesting carriers will combine the unbundled elements themselves." *Iowa Utils. Bd. v. FCC*, 120 F.3d at 813 (emphasis added).

In *IUB I*, this Court rejected the Eighth Circuit's interpretation of Section 251(c)(3), holding that the statute was *ambiguous*. This Court held that Section 251(c)(3) "does not say, or even remotely imply, that elements *must* be provided only [in discrete pieces] and never in combined form." *IUB I*, 525 U.S. at 394 (emphasis in original). The FCC's interpretation of "unbundled," this Court found, matched the only dictionary interpretation of that word: "'to give separate prices for equipment and supporting services.'" *Id.* (citation omitted). The Court thus deferred to the FCC's interpretation of Section 251(c)(3), finding that "[i]t was

entirely reasonable for the [FCC] to find that the text does not command [the] conclusion" that the provision "contemplates the leasing of network elements in discrete pieces." *Id.* Moreover, the Court found that "[i]n the absence of Rule 315(b) . . . incumbents could impose wasteful costs on [new entrants]." *Id.* at 395. The Court held that the FCC was right to prohibit such "an anticompetitive practice." *Id.* at 394-95.

In light of this Court's decision, a number of federal courts have held that state commissions may impose terms in interconnection agreements requiring ILECs to combine previously uncombined UNEs. *See U S W. Communications, Inc. v. MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999) ("It also necessarily follows from [this Court's decision in *IUB I*] that requiring [the ILEC] to combine unbundled network elements is not inconsistent with the Act: the . . . combination provision does not conflict with the Act because the Act does not say or imply that network elements may only be leased in discrete parts."), *cert. denied*, 120 S. Ct. 2741, *reh'g denied*, 121 S. Ct. 18 (2000); *MCI Telecomms. Corp. v. U S W. Communications, Inc.*, 204 F.3d 1262, 1268 (9th Cir.) ("The Supreme Court's interpretation of the Act makes absolutely clear that" a provision requiring combinations does not violate the Act.), *cert. denied*, 121 S. Ct. 504 (2000); *Southwestern Bell Tel. Co. v. Waller Creek Communications, Inc.*, 221 F.3d 812, 821 (5th Cir. 2000) ("There is nothing 'illegal' about the provision requiring [the ILEC] to combine network elements for [the new entrant]" because "[n]othing in the Telecommunications Act forbids such combinations."); *U S W. Communications, Inc. v. Hix*, Civ. No. 97-D-152 (consol.), Order at 13-14 (D. Colo. June 26, 2000) (interconnection agreement provisions "that require [the ILEC] to combine network elements at the request of new entrants are fully consistent with Section 251(c)(3) of the Act, as dispositively interpreted by the Supreme Court"). These courts upheld provisions requiring ILECs to combine UNEs as consistent with the Act and rejected the Eighth Circuit's

conclusion that Section 251(c)(3) forecloses such a requirement.

B. The Eighth Circuit Has Erred A Second Time In Holding That Section 251(c)(3) Unambiguously Requires New Entrants To Combine UNEs.

On remand, the Eighth Circuit reaffirmed its earlier decision to invalidate Rule 315(c)-(f) based on the same "plain language" interpretation of Section 251(c)(3) that this Court rejected in *IUB I*. *IUB II*, 219 F.3d at 759 (FCC Pet. App. 27a). The Eighth Circuit focused on the phrase "in a manner that allows requesting carriers to combine" in concluding that the statute unambiguously requires new entrants to do the combining. *Id.* (FCC Pet. App. 28a-29a). This holding ignores the important implications of the Court's *IUB I* decision. In restoring Rule 315(b), this Court implicitly rejected an interpretation of Section 251(c)(3) that precludes ILECs from being required to provide UNE combinations. Rule 315(b) prevents ILECs from separating already combined UNEs, meaning that ILECs must provide those UNEs to new entrants in *combined* form. Requiring ILECs to combine previously uncombined UNEs upon request is the "flip-side" of prohibiting them from separating already combined UNEs. In both instances, combined UNEs are being provided. There is no basis to say that the statutory provision is unambiguous in requiring new entrants to combine UNEs in one context, yet ambiguous enough to require ILECs to provide UNE combinations in the other.

The Eighth Circuit's holding also fails to give full effect to the statutory language. Section 251(c)(3) obligates ILECs to provide UNEs "in a manner that allows requesting carriers to combine such elements in order to provide [a] telecommunications service." 47 U.S.C. § 251(c)(3) (FCC Pet. App. 107a). The FCC correctly found that, in many instances, a requesting carrier would have no practical ability

to combine elements on an ILEC's network or could only do so through cumbersome and wasteful efforts. If the statutory language were read as narrowly as the Eighth Circuit suggests, the provision would be rendered a nullity, since requesting carriers would be effectively deprived of the ability to use combined UNEs "in order to provide a telecommunications service." The FCC properly determined that an ILEC's statutory duty to provide UNEs in the manner contemplated by Congress may require that the ILEC do the actual combining. As the FCC explained, Section 251(c)(3)'s language "means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service[; it] does not impose the obligation of physically combining elements exclusively on requesting carriers." *Local Competition Order*, 11 F.C.C.R. at 15,647 (¶ 294) (FCC Pet. App. 46a).

C. It Was Reasonable For the FCC To Promulgate A Regulation That Prevents ILECs From Engaging In An "Anti-competitive Practice."

Because Section 251(c)(3) is ambiguous, the Eighth Circuit should have deferred to the FCC's expertise in implementing the provision's requirements. *Accord IUB I*, 525 U.S. at 395, 397. Rule 315(c)-(f) ensures that new competitors are not "seriously and unfairly inhibited in their ability to use unbundled network elements to enter local markets." *Local Competition Order*, 11 F.C.C.R. at 15,647 (¶ 293) (FCC Pet. App. 45a). The FCC determined that a new entrant might lack sufficient information about the ILEC's network to be able to perform the combinations at all. In particular, the FCC noted that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent." *Id.*

These are the same types of competitive concerns that led this Court to reinstate Rule 315(b). The Eighth Circuit acknowledged that this Court's decision to reinstate Rule 315(b) "is rationally based on the nondiscrimination language in § 251(c)(3)," yet the Eighth Circuit never considered the potential for similar discriminatory or anticompetitive conduct as a reasonable justification for Rule 315(c)-(f). The only reason an ILEC would refuse to combine UNEs would be to impose unnecessary burdens and costs on new entrants. ILECs routinely combine UNEs and, because they control their networks, can do so much more efficiently than a new entrant. As long as the ILEC is fairly compensated for providing UNE combinations, there is no reason that new entrants—and ultimately their customers—should be forced to bear the additional costs, logistical delays, maintenance difficulties, and other burdens of attempting to combine elements on another carrier's network. These extra costs and delays, which ILECs do not suffer when serving their retail customers, would be pure economic waste borne exclusively by the new entrant, putting it at a substantial competitive disadvantage.

Recent developments illustrate the critical significance of Rule 315(c)-(f). The FCC has found that, in many contexts, "incumbent LECs have refused to provide access to network elements so that competitors could combine them." *In re Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. 3696, 3910 (¶ 482) (1999). Thus, as a practical matter, new entrants cannot simply take uncombined elements within the ILEC's network and combine them themselves. Absent a requirement that the ILEC do the combining, competitors in many instances will not be able to use UNEs—the most promising of the Act's mechanisms for developing competition—to provide local service. Rule 315(c)-(f) should be restored.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court reinstate 47 C.F.R. § 51.505(b)(1) and 47 C.F.R. § 51.315(c)-(f).

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent Sprint Corporation

JUN 7 2001

Supreme Court, U.S.
FILED
JUN 2 2001
CLERK

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *ET AL.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND
THE UNITED STATES OF AMERICA,
Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF RESPONDENT NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES

National Association of
State Utility Consumer
Advocates (NASUCA)
c/o Pennsylvania Office of
Consumer Advocate
555 Walnut Street 5th Fl.
Forum Place
Harrisburg, PA
17101-1923
(717) 783-5048

IRWIN A. POPOWSKY*
Consumer Advocate of Pennsylvania

PHILIP F. MCCLELLAND
Senior Assistant Consumer Advocate

JOEL H. CHESKIS
Assistant Consumer Advocate

**Counsel of Record*

June 8, 2001

BEST AVAILABLE COPY

QUESTIONS PRESENTED FOR REVIEW

Whether a utility can claim an unlawful confiscation under the Takings Clause where it has failed to demonstrate that the challenged rate decision has resulted in substantial harm to the financial integrity of the company.

Whether a utility can claim an unlawful confiscation by attacking the methodology employed in setting its rates absent a showing that the end result of the challenged order will have a significant adverse impact on its financial condition.

TABLE OF CONTENTS

QUESTIONS PRESENTED FOR REVIEW ..... -i-

TABLE OF CONTENTS ..... -ii-

TABLE OF AUTHORITIES ..... -v-

OPINIONS AND ORDERS BELOW ..... -1-

STATEMENT OF JURISDICTION ..... -1-

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED ..... -1-

STATEMENT OF THE CASE ..... -2-

SUMMARY OF THE ARGUMENT ..... -6-

ARGUMENT ..... -7-

I. Supreme Court Precedent Establishes the Principle That Utilities Do Not Have a Constitutionally Guaranteed Right to Recover Any Specific Type or Item of Cost. . . -7-

A. Introduction ..... -7-

B. Supreme Court Precedent Dictates That Verizon's Takings Claim Here Must Fail. ..... -9-

1. The Supreme Court Has Repeatedly and Consistently Held That, in Determining Whether a Rate Order Can Be Challenged as Confiscatory, It Is the Overall End Result Reached, Not the Method Employed, That Is Controlling. ..... -9-

2. The Supreme Court Has Rejected Arguments That Utilities Such as Verizon Have a Constitutional Right to Recover Every Dollar They Invest in Providing Utility Service, Even Where Those Investments Were Found to Have Been Prudently Made. ..... -12-

3. The Circuit Courts Have Correctly Recognized That TELRIC Cannot Be Found Unconstitutional On Its Face. ..... -15-

4. Verizon's Reliance on the Brooks-Scanlon Case is Misguided. ..... -18-

C. Verizon Has Not Demonstrated Here That A Takings Has Occurred. ..... -20-

1. Verizon Has No Factual Basis Upon Which to Demonstrate an Unconstitutional Taking Because the Overall Impact of the FCC Pricing Methodology on the Company's Financial Integrity Is Not Yet Known. ..... -20-

2. Actual Results Do Not Show That the FCC Pricing Methodology Has Had a Substantial Negative Impact on Verizon's Financial Integrity. ..... -24-

3. Verizon Has Failed To Account For Its Revenues From Many Sources In Its Constitutional Takings Claim. ..... -25-

II. The Supreme Court Has Rejected Challenges To Utility Rate Decisions On The Basis Of Objections To The Use Of A Particular Cost Recovery Methodology Or Specific Cost Allowances. ..... -28-

III. Verizon's Takings Claim is Premature, Speculative and Not Ripe For Review. ..... -32-

A. Verizon Does Not Have a Legitimate Takings Claim Because the Total Effect of The Challenged Order is Not Yet Known. ..... -32-

B. The FCC Order Under Review Has Not Deprived Verizon of Any of its Property. -34-

CONCLUSION ..... -37-

TABLE OF AUTHORITIES

CASES

Alabama State Federation of Labor, Local Union No. 103, United Brotherhood of Carpenters and Joiners of America, et al. v. McAdory, 325 U.S. 450 (1945) ..... -8-

Alenco Communications, Inc., et al. v. Federal Communications Comm'n, 201 F.3d 608 (5th Cir. 2000) -22-

AT&T Corp v. Iowa Utils. Bd., 525 U.S. 366 (1999) .... -4-

Baltimore & O.R. Co. v. United States, 345 U.S. 146 (1953) ..... -19-

Broad River Power Co. v. South Carolina, 281 U.S. 537 (1930) ..... -19-

Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396 (1920) ..... -18-,-19-

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) .. -6-, -8-, -11-, -12-, -14-, -29-, -30-

Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575 ..... -13-

FERC v. Pennzoil Producing Co., 439 U.S. 508 (1979) ..... -33-

FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) ..... -6-, -7-, -9-, -13-, -16-, -20-, -25-, -28-

FPC v. Texaco Inc., 417 U.S. 380 (1974) ..... -32-

Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America, 219 F.3d 744 (8th Cir. 2000) ..... -1-, -2-, -8-, -16-, -17-, -20-

Iowa Utils. Bd. v. F.C.C., 120 F.3d 753 (8th Cir. 1997) .. -4-

Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) ..... -10-, -11-

Keystone Bituminous Coal Association v. DeBenedictis, 480 U.S. 470 (1987) ..... -15-, -21-

MacDonald, Sommer & Frates v. Yolo County, 477 U.S. 340 (1986) ..... -21-

Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945) ..... -13-

Missouri Pacific Ry. Co. v. Kansas, 216 U.S. 262 (1910) ..... -19-

Mobil Oil Corp. v. FPC, 417 U.S. 283 (1974) ..... -32-

National Mining Association v. Babbitt, 172 F.3d 906 (D.C. Cir. 1999) ..... -34-

Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978) ..... -21-

In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968). . . -11-

Smith v. Illinois Bell Tel. Co., 282 U.S. 133 (1930) ..... -19-

Tenoco Oil Co. v. Dept. of Consumer Affairs, 876 F.2d 1013 (1st Cir. 1989) ..... -21-

Texas Office of Public Utility Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. dismissed*, 121 S.Ct. 423, 148 L.Ed.2d 327 (2000) ..... -17-

United States v. Riverside Bayview Homes, 474 U.S. 121 (1985). ..... - 34-

Qwest Corporation v. United States, 48 Fed.Cl. 672 (February 20, 2001). ..... -36-

ADMINISTRATIVE DECISIONS

In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 F.C.C.R. 15499 (1996) ..... -1-, -2-, -3-, -4-, -22-, -29-, -34-, -35-

STATUTES & REGULATIONS

U.S. Const. amend. V ..... -1-

Telecommunications Act of 1996,
Pub. L. No. 104-104, 110 Stat. 56. ..... -1-, -2-

28 U.S.C. § 1254(1) ..... -1-

47 U.S.C. § 251 ..... -3-, -19-

47 U.S.C. § 251(c)(2) . . . . . -3-

47 U.S.C. § 251(c)(3) . . . . . -3-

47 U.S.C. § 252(d)(1) -3-, -7-, -8-, -11-, -12-, -14-, -17-, -29-, 31-, -36-

MISCELLANEOUS

Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC, 52 Fed. Com. L.J. 239 (March 2000) . . . . . -24-

OPINIONS AND ORDERS BELOW

The Opinion and Order of the Eighth Circuit Court of Appeals is reported at *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000).

The Order of the Federal Communications Commission which is the subject of this appeal is reported at *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15499 (1996).

STATEMENT OF JURISDICTION

This Court has jurisdiction of this matter under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

This matter involves the Takings Clause of the Fifth Amendment to the United States Constitution, U.S. Const. amend. V; and the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56. The Telecommunications Act of 1996 amends the Communications Act of 1934, 47 U.S.C. § 151, *et seq*.

STATEMENT OF THE CASE

The instant matter comes to this Court on a challenge by Verizon Communications, Inc. ("Verizon") and other telecommunications companies of the decision of the Eighth Circuit Court of Appeals in the matter of *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000)("*Iowa III*"). The *Iowa III* case dealt with challenges mounted by a number of parties to an Order by the Federal Communications Commission ("FCC") in its efforts to implement the local telephone competition provisions of the Telecommunications Act of 1996 ("Telecom Act").

The Telecom Act fundamentally changes telecommunications from a regulatory regime in which government encouraged monopolies, to a new regulatory regime where the barriers that protected monopolies from competition are removed, competition is affirmatively promoted, and new measures are created to support the provision of universal service. *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15499 ("*Local Competition Order*"). As the FCC recognized in its *Local Competition Order*, historically, regulation of the telecommunications industry has been premised on the belief that service could be provided at the lowest cost to the maximum number of consumers through a regulated monopoly network. *Id.* at 15505. State and federal regulators devoted their efforts over many decades to regulating prices and practices of these monopolies and protecting them against competitive entry. The Telecom Act, however, adopts a different approach by requiring telephone companies to open their networks to competition. *Id.*

Sections 251 and 252 of the Telecom Act provide the specifics for how competition for the provision of local telephone service is to develop. In Section 251, Congress created the obligation for incumbent local exchange carriers ("ILECs") to allow their competitors, competitive local exchange carriers ("CLECs"), to interconnect with their network so that they may use those facilities to provide competing local telephone service. *See*, 47 U.S.C. § 251. Section 251 requires ILECs to provide such interconnection that is at least equal in quality to that provided by the ILEC to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(2). Congress also requires ILECs to provide such access to individual network elements on an unbundled basis, called UNEs (unbundled network elements), at rates, terms and conditions that are just, reasonable and nondiscriminatory so that a CLEC can combine such UNEs in order to provide a competing telecommunications service. 47 U.S.C. § 251(c)(3).

In Section 252, Congress articulated the procedures for negotiating, arbitrating and approving the interconnection agreements as well as the rates for UNEs. In particular, Section 252 provides that the rates for interconnection of facilities and UNEs as provided for in Section 251 shall be just and reasonable and based on the cost (determined without reference to a rate of return or other rate-based proceeding) of providing the interconnection or network element. 47 U.S.C. § 252(d)(1). This section also provides that the rates shall be nondiscriminatory and may include a reasonable profit.

The FCC, in issuing the *Local Competition Order*, adopted initial rules designed to implement Sections 251 and 252 of the Telecom Act and accomplish the goal of opening the local exchange and exchange access markets to competition. *Local Competition*

Order at 15507. Of particular relevance, the FCC's *Local Competition Order* established rules setting forth the pricing methods for states to use in setting prices if the ILEC and CLEC could not reach their own agreement. *Id.* at 15812. More specifically, the FCC established a forward-looking cost methodology known as Total Element Long Run Incremental Cost ("TELRIC") that sets prices of interconnection and access to UNEs based on forward-looking, economic costs that best replicate, to the extent possible, the conditions of a competitive market. *Id.* at 15846.

In this matter, Verizon bases its attack on the constitutionality of the FCC's Order, *inter alia*, on the premise that TELRIC allegedly will not allow the company to recover all the costs it believes it has incurred in the fulfillment of its interconnection obligations. Verizon Brief at 28. Verizon argues that the FCC's TELRIC rules have devalued the existing network and thus undercompensate carriers for the network elements they are compelled to provide to competitors under the Telecom Act. *Id.*

This is the second time an issue arising from the FCC's implementation of the *Local Competition Order* has been heard by this Court. In *AT&T Corp v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) ("*Iowa II*"), this Court affirmed in part, reversed in part, and remanded the Eighth Circuit's original decision, *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997) *("Iowa I")*, regarding the FCC's rules established in the *Local Competition Order*. *See, Iowa III*. At that time, this Court, *inter alia*, reversed the portion of the Eighth Circuit's opinion pertaining to jurisdiction and held that the FCC had jurisdiction to design a pricing methodology. *Id.* at 748. On remand, the Eighth Circuit reviewed the merits of the FCC's forward-looking pricing methodology, proxy prices and wholesale

pricing provisions. *Id.* That review of the merits of TELRIC is now before this Court on appeal by Verizon.

The National Association of State Utility Consumer Advocates ("NASUCA"),[1] a party to the proceedings below, submits this Brief in opposition to Verizon. In particular, NASUCA urges this Honorable Court to reject the suggestion that the Orders below are in any way confiscatory or in violation of the Takings Clause of the Fifth Amendment to the United States Constitution.

---

[1] NASUCA is an association of 42 consumer advocate offices in 39 states and the District of Columbia and includes members designated by the laws of their respective states to represent the interests of utility consumers before state and federal regulators and in the courts.

SUMMARY OF THE ARGUMENT

For more than half a century, this Court has consistently adhered to the principle that a utility cannot claim an unconstitutional confiscation of property in the ratemaking context unless it can first show that the complained of regulatory action has resulted in real financial harm to the company.[2] In reviewing an order that affects the rates of a utility, the Court has held that, "it is the result reached not the method employed which is controlling," and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope*"). This Court reiterated this basic lesson of *Hope* in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989) ("*Duquense*"), where it stated that, "Today we reaffirm these teachings of *Hope Natural Gas*: '[I]t is not theory but the impact of the rate order which counts.'" *Duquesne* at 310.

Verizon's appeal directly challenges and urges this Court to overturn more than fifty years of constitutional law in the utility ratemaking context. Verizon challenges the TELRIC methodology without any effort to show that the total effect is unjust or that the Order will produce a substantial negative financial impact. Verizon thus fails to meet the threshold test for showing that the Order was confiscatory in violation of the Fifth Amendment.

---

[2] While Petitioner Verizon addresses a number of issues in this appeal, NASUCA deals solely in its Brief with Petitioner Verizon's Fifth Amendment confiscation arguments.

ARGUMENT

I. Supreme Court Precedent Establishes the Principle That Utilities Do Not Have a Constitutionally Guaranteed Right to Recover Any Specific Type or Item of Cost.

A. Introduction

In its Brief in this matter, Petitioner Verizon argues that the requirement that rates be "just and reasonable" through Section 252(d)(1) of the Telecom Act incorporates the Fifth Amendment's assurance of just compensation. Verizon Brief at 24. While this principle is correct in the abstract, Verizon vastly overstates the impact of that principle in this case by suggesting that it has a constitutional right to recover every element of its historically incurred costs. As noted below, this has not been the law of the land since at least 1944.

This Court's precedent establishes the principle that utilities do not have a constitutionally guaranteed right to recover any specific type or item of cost. More than fifty years ago, this Court established the principle that a utility cannot claim an unconstitutional confiscation unless the overall rates set for that utility result in substantial harm to the financial integrity of the company. In the landmark decision in *Hope*, this Court ruled that, "it is the result reached not the method employed which is controlling" and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry... is at an end." 320 U.S. at 602. The underlying principle of *Hope* is that a utility does not have a constitutional right to recover costs associated with specific items of investment. Rather, it is the overall impact of the rates established for that utility that control whether a utility may claim an unconstitutional taking. *Id.*

The *Hope* decision was expressly affirmed by this Court in 1989 in rejecting the challenge of two Pennsylvania electric utilities that claimed a constitutional right to recover the costs for four cancelled nuclear power plants. In *Duquesne*, this Court stated that, "Today we reaffirm these teachings of *Hope Natural Gas*: '[I]t is not theory but the impact of the rate order which counts.'" *Duquesne* at 310. Verizon's suggestion that its confiscation claim in this case is somehow supported or compelled by this Court's decision in *Duquesne,* Verizon Brief at 17, 27, 34, is utterly without merit.[3]

---

[3] Verizon's prayer that this Court adjudicate the company's constitutional claim is particularly inappropriate in light of this Court's long standing practice to avoid deciding hypothetical questions:

> This Court is without power to give advisory opinions. It has long been its practice not to decide abstract, hypothetical or contingent questions, or to decide any constitutional question *in advance* of the necessity for its decision, or to formulate a rule of constitutional law broader than is required by the precise facts to which it is to be applied.

Alabama State Federation of Labor, Local Union No. 103, United Brotherhood of Carpenters and Joiners of America, et al. v. McAdory, 325 U.S. 450, 461 (1945) (emphasis added, citations omitted). Until the actual rates can be reviewed, Verizon's takings claim is not ripe for consideration as the Eighth Circuit found. *Iowa III* at 754. NASUCA will discuss the lack of ripeness in a later section of this argument.

B. Supreme Court Precedent Dictates That Verizon's Takings Claim Here Must Fail.

1. The Supreme Court Has Repeatedly and Consistently Held That, in Determining Whether a Rate Order Can Be Challenged as Confiscatory, It Is the Overall End Result Reached, Not the Method Employed, That Is Controlling.

In the landmark decision of *FPC v. Hope Natural Gas*, *supra*, the United States Supreme Court ended decades of constitutional review of minute ratemaking details when it declared that, for purposes of its review, "it is the *result reached* not the method employed which is controlling," and that "[i]f the *total effect of the rate order* cannot be said to be unreasonable, judicial inquiry ... is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *Hope* at 602 (emphasis added). *Hope* thus marked the end of an era of judicial intervention in utility ratemaking decisions during which the courts had ruled that, as a matter of constitutional right, the "fair value" of the property on which a utility's rates were set had to include some measure of the present value or reproduction cost, rather than be based upon the original or historical cost of the property. *Id.* at 599-600.

NASUCA submits that the *Hope* decision essentially established a two-part test to examine utility confiscation claims arising from a rate order. First, the Court will determine whether the end result of the rate order produces substantial harm to the investor interest. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and the constitutional review of the rate order is at an end. Second,

if the rate order results in substantial harm to investors, the Court will then examine whether such harm is justified by countervailing public policy or consumer interests. In *Hope*, the Court did not reach the second part of the test because it found that the end result did not substantially harm investor interests. *Id.* at 603.

The scope of the *Hope* decision was perhaps most thoroughly discussed in a 1987 decision of the District of Columbia Circuit Court of Appeals. In the *en banc* decision in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987), three separate opinions emerged, discussing which rule to use to determine a regulatory taking under *Hope*. Judge Bork, writing for the majority, said it was necessary to consider all "prudent investment"; the dissenting opinion authored by Judge Mikva advocated the application of the "used and useful" rule; and Judge Starr, while voting with the majority, suggested that it was appropriate to consider a combination of both measures to arrive at a balanced determination. *Jersey Central* at 1169, 1188, 1194.

Most important here, however, despite this disagreement regarding how much of the utility's property to consider in deciding a takings claim under *Hope*, there was no dispute in the *Jersey Central* case that, under this Court's precedents, there can be no finding of a taking without a showing of substantial financial harm to the utility. As the majority opinion explained:

> Under *Hope*, as we have stated repeatedly, the only circumstance under which there is a *possibility* of a taking of investors' property by virtue of rate regulation is when a utility is in the sort of financial difficulty described in Justice Douglas' opinion. ..... But absent the sort of *deep financial hardship* described in *Hope*, there is no taking, and hence no

> obligation to compensate, just because a prudent investment has failed and produced no return.

Jersey Central at 1181 n.3 (emphasis added). Under the present record in the appeal to this Court, Verizon has not alleged -- nor could the company demonstrate -- the requisite "deep financial hardship" described above.

The United States Supreme Court has clearly found no constitutional flaw in the fact that certain rates might not permit some utilities to recover a return of and a return on all of their investments. In *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Court held that there was "no constitutional infirmity" in the adoption of an area rate system for certain gas producers. *Id.* at 774. The Court upheld, as a matter of administrative necessity, a ratesetting procedure that was based on the *average* costs of a large number of natural gas producers and did not specifically address the investor interests in the capital costs of individual producers. The Court noted that, while the investor interests set forth in *Hope* remain "pertinent," they "scarcely exhaust the relevant considerations." *Permian Basin* at 791.

Any doubt that it is the result reached, not the method employed, that is of constitutional significance was eliminated by the Supreme Court's decision in *Duquesne*. In that case, two Pennsylvania electric utilities were denied *any recovery whatsoever* for costs that were incurred on four cancelled nuclear power plants. This Court decided that utilities could not claim an unlawful taking even if they received *zero recovery* of certain specific cost items unless they could show that the *overall* rate levels were not just and reasonable. The Court held that a "scheme of utility regulation does not 'take' property simply because it disallows recovery of capital investments that are not 'used and useful in service to the public,'"

even where it excludes costs that were prudent and reasonable when made. *Id.* at 301-02. In so doing, the Court reemphasized, "Today we reaffirm these teachings of *Hope*: '[I]t is not theory but the impact of the rate order which counts.'" *Id.* at 310.

2. The Supreme Court Has Rejected Arguments That Utilities Such as Verizon Have a Constitutional Right to Recover Every Dollar They Invest in Providing Utility Service, Even Where Those Investments Were Found to Have Been Prudently Made.

Verizon argues that the FCC applied the wrong standard of "financial integrity" that "limited its inquiry to revenues for which it was responsible and instead sought to conscript all of an incumbent's revenues to cure the obvious inadequacy of TELRIC rates." Verizon Brief at 36. Verizon argues that this standard is impermissible and that the FCC erred in failing to conduct the inquiry allegedly demanded by *Duquesne* to see whether the TELRIC rates for UNEs will preserve the ILECs opportunity to recover their past prudent investments.

Prior to *Hope*, this Court and other appellate courts engaged in the very type of constitutional judicial scrutiny that Verizon is calling on this Court to perform here. In many of those early cases, the utilities argued that they had a constitutional right to recover reproduction costs (or fair value), which were ostensibly higher than original or embedded costs. The Court in *Hope* upheld the use of original cost by the Federal Power Commission, but more importantly concluded that it is the end result reached, not the methodology employed, that is controlling. In the present matter, by focusing on certain embedded costs and the purported infirmities of

the FCC's forward-looking treatment of costs, Verizon demonstrates its misconception that utility investors have a constitutionally guaranteed interest in the recovery of specific items of cost or investment, rather than the overall justness and reasonableness of their rates.

Indeed, decisions from this Court after *Hope* confirmed that there are instances in which less might be allowed than is necessary to satisfy even the overall investor interests described in *Hope*. For example, just one year after *Hope*, the Court unanimously ruled in *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548 (1945), that the rates set for a failing street railway company were not confiscatory. In response to the company's claim that the rate order was confiscatory under *Hope* because it did not insure the financial integrity of the enterprise, the Court responded:

> It was noted in the *Hope Natural Gas* case that regulation does not assure that the regulated business make a profit. 320 U.S. at 603; *see, Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590. All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.

Market Street Railway at 566.

In the present case, Verizon insists that, "the FCC's duty – both under [Takings] principles and the express directive of Section 252 – was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own." Verizon Brief at 35. Whatever Verizon means by "UNE business" "standing on its own," it is clear that the Constitution does not guarantee that a utility will

recover every dollar of investment on any particular service. Nor does the Constitution guarantee that the utility will make a profit on every investment.

In *Duquesne*, the Court summarily rejected the suggestion that utilities are constitutionally entitled to a return of and on all prudent investment. The Court stated that selection of a single prudent investment standard would "signal a retreat from 45 years of decisional law." *Id.* at 315.[4] Furthermore, the Court stated that "an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it." *Id.* at 314. In the instant appeal, it is the FCC methodology that Verizon attacks, without any demonstration that the end result is unjust and unreasonable.

To suggest, as Verizon does, that *Duquesne* stands for the proposition that utilities have a constitutional right to recover all of their costs is simply wrong. With respect to the specific investments at issue in *Duquesne*, the utilities did not recover their historical cost; they did not recover their incremental cost; they did not recover anything. In *Duquesne*, this Court upheld its long-standing constitutional standard and decided that, unless the overall end result was unjust and unreasonable, the utilities had no constitutional claim.

Furthermore, when the Court has been faced with the question of whether an unconstitutional confiscation has occurred in the ratemaking context, it has examined the overall rates, not each specific item comprising those rates. This is consistent with the

---

[4] The Court noted that such a standard would be particularly inappropriate in light of the emergent competitive wholesale market for electric generation. *Id.* at 316 n.10.

Court's general "takings" jurisprudence where the Court has compared the value of the property allegedly taken to the value of the entire property at issue. As the Court explained in *Keystone Bituminous Coal Association v. DeBenedictis*, 480 U.S. 470 (1987):

> Because our test for regulatory taking requires us to compare the value that has been taken from the property with the value that remains in the property, one of the critical questions is determining how to define the unit of property 'whose value is to furnish the denominator of the fraction.'

Id. at 497. Thus, the Court must consider the "numerator" and the "denominator" in the financial equation to define the extent of the harm suffered by the utility as a result of the regulatory action under review.

3. The Circuit Courts Have Correctly Recognized That TELRIC Cannot Be Found Unconstitutional On Its Face.

According to Verizon, it is the "objective of a utility ratemaking regime to avoid future government liability for an uncompensated taking by requiring the regulator to design rates that will fully compensate the utility." Verizon Brief at 24. Verizon then argues that applicable legal principles require recovery of every dollar invested in its utility operations. *Id.* at 25. In the instant case, Verizon has failed to meet the threshold requirements prescribed by *Hope* to establish an unconstitutional confiscation. Rather, Verizon has produced only a few isolated instances where TELRIC may produce rates that are lower than historical costs. *Id.* at 10, 14.

The Eighth Circuit noted below that the rates for UNEs were to be set by state commissions and, therefore, were largely yet unknown. *Iowa III* at 754. Verizon has not provided any comprehensive data concerning the impact of the FCC's Order on the financial aspects of its operations. Verizon has not provided any evidence tending to show that the Company has suffered a substantial negative impact as a result of the FCC's Order. Instead, Verizon complains that the FCC failed because it did not explicitly preserve the ability of incumbents to recover all costs they have incurred in building the present network. Verizon Brief at 25. This is not the constitutional standard set forth in *Hope*.

In rejecting Verizon's Takings argument, after reviewing all of the Verizon data presented, the Eighth Circuit below held that:

> The Constitution protects public utilities from rates which are "so unjust as to be confiscatory." However, a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself. "It is not theory but the impact of the rate order which counts." Until the actual rates are established we cannot conclude whether the impact of TELRIC driven rates will constitute a taking. "It is not enough that a party merely speculates that a government action will cause harm." ... The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the

> resulting rates have been determined and applied, the constitutional claim is not ripe.

Iowa III at 754 (citations omitted).

The Fifth Circuit has also addressed the issue of whether a takings has occurred in the context of the FCC using TELRIC to establish universal service funding. In *Texas Office of Public Utility Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999), *cert. dismissed*, 121 S.Ct. 423, 148 L.Ed.2d 327 (2000), GTE argued that TELRIC was unconstitutional because it left ILECs exposed to competition without first implementing a new universal plan that results in a reduction of its revenues from local service. *Id.* at 437. The Fifth Circuit held that GTE's takings claim "has no merit because it has not shown that a taking has occurred or that any taking will be permanent or would be so serious as to be considered 'confiscatory.'" *Id.* at 413, fn. 14. The Fifth Circuit also held that "even if GTE can show that some taking will result, it must demonstrate that its losses are so significant that the 'net effect' is confiscatory." *Id.* at 437. The Fifth Circuit held that:

> GTE has failed to meet the requirements of *Duquesne* because it cannot show that it will lose any revenue at all, much less enough to constitute a taking under more recent precedent. ... *Duquesne* does not require courts to engage in a takings analysis whenever an agency opens a previously regulated market to competition.

Id.

4. Verizon's Reliance on the Brooks-Scanlon Case is Misguided.

Verizon argues that, where a regulator controls revenues in only a segment of a firm's overall business, the regulator may only look at that specific enterprise in determining whether the overall end result of its Order is just and reasonable. Verizon cites this Court's decision in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920), to support that position. Verizon further argues that the FCC's duty under Section 252 was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own and ensure that UNE rates fully cover the costs of that business. *Id.* at 35.

Verizon's reliance upon *Brooks-Scanlon* is unfounded. In *Brooks-Scanlon*, a sawmill had developed a railroad as a subsidiary business in order to bring logs to the sawmill. *Brooks-Scanlon* at 398. After all of the timber had been cut, the railroad operated at a loss, but Brooks-Scanlon was denied permission by the Louisiana Railroad Commission to terminate its railroad operation. The United States Supreme Court reversed that decision. In that case, the Supreme Court held that where a railroad serving the public is owned and operated by a lumber company, it is the business of the railroad, and not the profits from the lumber company, that determined whether the railroad may abandon regulated service as unprofitable.

The applicability of *Brooks-Scanlon* to the issues in the present case, however, is called into question by subsequent decisions of this Court. In *Broad River Power Co. v. South Carolina*, 281 U.S. 537 (1930), the Supreme Court explained that its holding in *Brooks-Scanlon* was made on the basis that "the private business, the lumber company, was not devoted to a public use or a part of the public franchise." *Id.* at 544. In the *Broad River*

case, the Court considered the overall business of a profitable electric company and its unprofitable subsidiary railway, both of which were devoted to a public use. Similarly, in *Baltimore & O.R. Co. v. United States*, 345 U.S. 146 (1953), when a railroad complained that its rates for carrying certain kinds of vegetables were confiscatory, the Court responded that, "So long as a railroad is not caused by such regulation to lose money on its overall business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.'" *Id.* at 148.

A critical fact in *Brooks-Scanlon* was that the utility owner wished to withdraw entirely from offering any public utility service. The Court agreed that it should be permitted to exit the railroad business, but explained that, if a public utility wished to continue to operate under its regulatory charter, then a regulatory commission "may require it to fulfill an obligation imposed by the charter even though fulfillment in that particular may cause a loss." *Brooks-Scanlon* at 399 (citing *Missouri Pacific Ry. Co. v. Kansas*, 216 U.S. 262, 276, 278 (1910)). Verizon certainly has not suggested that it wishes to abandon its vast telecommunications network. Nor has Verizon suggested that the FCC is forcing it to operate its telecommunications network at a loss. The *Brooks-Scanlon* case does not support Verizon's position in this case.

Clearly, Verizon's operations are much more diverse than the Brooks-Scanlon Company's operations were. Verizon has many segments of its business from which it draws revenues and it is unclear which segment or segments, and the accompanying revenues, Verizon believes should be excluded in the total effect test. *See*, Verizon Brief at 33. Verizon cites *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930), for the proposition that a regulator may not justify deficient rates by pointing to revenues from operations under

a different sovereign's jurisdiction. NASUCA submits that Verizon provides many services over the same physical plant and that all revenues from such services should be considered in the overall end result test.

C. Verizon Has Not Demonstrated Here That A Takings Has Occurred.

1. Verizon Has No Factual Basis Upon Which to Demonstrate an Unconstitutional Taking Because the Overall Impact of the FCC Pricing Methodology on the Company's Financial Integrity Is Not Yet Known.

Because *Hope* and its progeny establish that the courts must consider the *end result* of the regulation, it becomes apparent that the record in this matter is simply not sufficient to support the sweeping claims of confiscation made by Verizon. The Court thus lacks the factual predicate upon which to make such a determination. In fact, the Eighth Circuit, in *Iowa III* below, found that it was unsure how TELRIC would affect state rates for interconnection and UNEs. The Eighth Circuit held that, "until the actual rates [under TELRIC] are established, we cannot conclude whether the impact of TELRIC driven rates will constitute a taking" and that "because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates have been determined and applied, the constitutional claim is not ripe." *Iowa III* at 754.

Under traditional "takings" jurisprudence, the Court must engage in "essentially *ad hoc*, factual inquiries" that address such factors as 1) the economic impact of the regulation; 2) the nature of the government action; and 3) the extent to which the regulation has

interfered with investor-backed expectations. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). At the present time, Verizon and the other incumbents have presented this Court with little more than a competing alternative theory to the FCC's pricing methodology, virtually devoid of the essential facts regarding economic impact or interference with investor-backed expectations by which this Court could conclude that the FCC's pricing methodology, once applied, would effect a taking. Verizon's assertion of harm is based on a few isolated instances where TELRIC may produce rates lower than historical costs. Verizon Brief at 10, 14. Otherwise, Verizon's assertion is conditioned upon factors in the future and is wholly speculative.

In the instant matter, Verizon has not sufficiently specified the value of the property allegedly taken, and it has failed to set forth the value of the entire property at issue. Because of the absence of this critical information, Verizon cannot claim, much less prove, that the FCC's Order has caused substantial harm to its financial condition. Absent an allegation of a significant negative impact on its financial condition, Verizon cannot claim an unconstitutional confiscation. In particular, Verizon cannot satisfy the test set forth in *Keystone Bituminous Coal*, *supra*, based on the record before the Court.

There is absolutely no basis at this time for the Court to conclude that the application of the FCC pricing rules will have a confiscatory impact. "A court cannot determine whether a regulation has gone 'too far' unless it knows how far the regulation goes." *MacDonald, Sommer & Frates v. Yolo County*, 477 U.S. 340, 348 (1986). Further, an administrative agency is entitled to observe the actual result of the operation of its regulations for a reasonable period of time before a court could conclude that the agency's actions were arbitrary or capricious. *Tenoco Oil Co. v. Dept. of Consumer Affairs*, 876 F.2d 1013, 1028 (1st Cir. 1989). In

Tenoco Oil, the First Circuit held that a takings clause challenge to gasoline pricing restrictions was not ripe for constitutional review, in large measure because the record was not adequately developed, and the agency had expressed a willingness to adjust its price order upon receipt of subsequent evidence. *Tenoco Oil* at 1026. The Court emphasized that until the wholesalers had requested and been refused relief pursuant to procedures set forth in the agency's order, a federal court could not yet know whether the agency's regulations confiscate property. *Id.*

Indeed, the FCC itself has recognized the evolving and fact-specific nature of its *Local Competition Order*:

> Incumbent LECs may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates. We also do not completely foreclose the possibility that incumbent LECs will be afforded an opportunity to recover, to some extent, their embedded costs through a mechanism separate from rates for interconnection and unbundled network elements. As stated above, we intend to explore this issue in detail in our upcoming access reform proceeding.

Local Competition Order, 11 F.C.C.R. at 15872, ¶ 739.

Although the Fifth Amendment protects utilities from regulatory actions that are so unjust as to be confiscatory, "[i]t is not enough that a party merely *speculates* that a government action will cause it harm." *Alenco Communications, Inc., et al. v. FCC*, 201 F.3d 608, 624 (5th Cir. 2000) (emphasis added). In *Alenco*, a large

number of rural local telephone companies challenged two FCC Orders promulgated to make changes to universal service consistent with the Telecom Act. The telephone companies in *Alenco* made takings claims similar to those raised by Verizon in its brief in this matter, and the Fifth Circuit Court flatly rejected those claims. The Court found that the phone companies in *Alenco* had failed to show a taking because they relied on mere speculation to support their Fifth Amendment arguments. The *Alenco* Court explained that:

> petitioners must wait to experience the actual consequences of the Order before a court may even begin to consider whether the FCC has effected a constitutional taking. Until it is known what level of universal service funding each petitioner will receive under the Order, and under what circumstances the Commission will grant a waiver, we cannot seriously entertain a Takings Clause challenge.

Alenco at 624.

In the instant matter, Verizon is in the same position as the *Alenco* petitioners. Verizon cannot be said to have made a sufficient showing of a taking because none of the deprivations of company property claimed by Verizon has occurred. In fact, there is no evidence that Verizon has experienced any financial harm due to the FCC's Order, and even if such an adverse effect would ever materialize, it might not amount to an unconstitutional taking under the Fifth Amendment to the U.S. Constitution.

2. Actual Results Do Not Show That the FCC Pricing Methodology Has Had a Substantial Negative Impact on Verizon's Financial Integrity.

Presently, there is no indication that the FCC's pricing rules have resulted in the type of deep financial hardship necessary to show an unconstitutional taking. In fact, there is publicly reported data indicating that the FCC's TELRIC methodology has not resulted in financial losses for the incumbents. In the March 2000 edition of the Federal Communications Law Journal, economists David Gabel and David I. Rosenblum presented data that indicate that no taking has resulted from TELRIC pricing. Gabel & Rosenblum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Com. L.J. 239 (March 2000). Following a review of financial information submitted to the FCC by 150 of the largest telephone companies in the country, Messrs. Gabel and Rosenblum concluded that:

> Given the rates of return on regulated investment, and the rates of return on embedded investment, it seems clear that the majority of telephone companies in the survey are earning returns that are more than sufficient to assure confidence in the financial integrity of their enterprises, maintain credit worthiness and to enable them to attract additional capital. Based on this data it would seem that the ILECs and their supporters' contention, that the use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports.

52 Fed. Com. L.J. at 265 (footnote omitted).

Publicly available FCC reports also suggest that Verizon continues to realize substantial earnings from its investments. Financial reports from the FCC demonstrate in 1999 that Verizon and other regional Bell operating companies and the former GTE realized net income of $11.8 billion on stockholder's equity of $60.8 billion.[5] Verizon certainly has not demonstrated that the FCC has forced it to operate at a loss, or indeed anything less than a very substantial level of profit. There is no basis at this time to conclude that the FCC has not fully satisfied the investor interest under the standards announced in *Hope*. *Hope* at 603.

3. Verizon Has Failed To Account For Its Revenues From Many Sources In Its Constitutional Takings Claim.

NASUCA has explained above the many reasons why Verizon has failed to present a constitutional claim that the Court should recognize. Even if the Court finds that Verizon has presented a constitutional claim that the court should review, Verizon has failed to acknowledge the many sources of revenues that must be considered in reviewing such a takings claim.

The crux of Verizon's argument appears to be that "TELRIC violates the Just Compensation Clause because it represents a fundamental shift in methodology that makes no provision for the recovery of prior prudent investment, but rather is designed to preclude such recovery." Verizon Brief at 17. Verizon asks this

---

[5] FCC Statistics of Communications Common Carriers for 1999, pages 57, 61 at Table 2.10 available online at http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/socc.html

Court to make a constitutional determination concerning an assumed shortfall of revenues below its costs without adequately explaining what revenues should be counted in comparison to costs and why certain revenues should be dismissed from the revenue/cost analysis. A fundamental problem with this argument is that Verizon has not even adequately explained what Verizon service revenues should be considered in comparison with Verizon's costs in any constitutional takings analysis.

Verizon has presented no authority by which it can contend that it is constitutionally entitled to recover specific costs of providing access to its network to competitors through interconnection or UNEs. Verizon still has an opportunity to recover its costs from the myriad of services that it sells to its customers, as well as from other funds.[6] Neither the Telecom Act nor the United States Constitution guarantee full cost recovery from only one category of service.

---

[6] For example, GTE, Inc., which merged with Bell Atlantic to form Verizon, recovers revenues from state Universal Service Funds pursuant to 47 U.S.C. § 254(c) and (f), which must also be taken into account. Verizon has failed to offer any information concerning this source of revenue.

Verizon reported $15.2 billion of total revenue to the FCC in 1999. This includes $4.8 billion of "Basic Area Revenue" realized for local service or universal service. The remaining revenue is produced by optional vertical services, access revenues received from interexchange carriers, long distance revenues, telephone directory revenues, etc. FCC Statistics of Communications Common Carriers for 1999, page 58 at Table 2.10, available online at http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/socc.html

Verizon does not have a constitutional right to earn a profit on every telephone call it carries. Nor does it have a constitutional right to earn a profit from every customer it serves. Verizon also has no constitutional right to recover all of the costs of its multiple products and services network only through interconnection and UNE rates. NASUCA respectfully submits that this Court must view Verizon's constitutional takings claim in light of the many services that Verizon sells to consumers over similar facilities. Verizon's vast network is used in a joint and common fashion to produce a wide array of telephone services in addition to TELRIC based UNE services. Revenue to cost relationships will necessarily vary based upon the characteristics of the customers, the services they purchase and whether the services are offered in a retail or wholesale market. Verizon should not prevail on a theoretical takings claim based upon TELRIC pricing to a part of its markets.

NASUCA emphasizes that what ultimately matters under the test set forth in *Hope* "is whether that order 'viewed in its entirety'" presents a constitutional takings claim. *Hope* at 602. In order to examine Verizon's takings claim, this Court must consider the financial position of Verizon in light of the broad range of revenues that it receives related to its vast array of telecommunications operations. Any such consideration will lead to the conclusion that Verizon has not suffered the type of overall financial harm that is necessary to raise a constitutional takings claim.

II. The Supreme Court Has Rejected Challenges To Utility Rate Decisions On The Basis Of Objections To The Use Of A Particular Cost Recovery Methodology Or Specific Cost Allowances.

In its Brief in this matter, Petitioner Verizon argues that the FCC's implementation of TELRIC represents a fundamental shift in methodologies which "necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime." Verizon Brief at 26. Verizon's request constitutes an attempt to have this Court reject 50 years of established takings doctrine in the context of utility regulation. Verizon asks this Court to declare the FCC's TELRIC methodology unconstitutional under the Fifth Amendment even though the Company has not even attempted to demonstrate that it has suffered substantial financial harm. Adopting Verizon's approach would immerse the Court in a constitutional examination of ratemaking theory for the telecommunications industry. This is exactly the sort of action the Court refused to take in *Hope* and its progeny. As stated above, this Court has repeatedly stated that, in deciding a takings claim, it will not look to the methodology employed in arriving at utility rates. Instead, this Court has stated that it will first examine the end result of the rate decision to determine whether a confiscation claim can even be made. *Hope* at 602; *Duquesne* at 310.

NASUCA submits that, establishing a new methodology for a new rate element, UNE rates, does not represent a taking. Rather, the FCC Order represented a necessary development in order to carry out its Congressional mandate to move toward the new competitive environment envisioned under the Telecom Act. In passing the Telecom Act, Congress created a new rate element which did not exist before, *i.e.*, the rate for a particular network

element if sold separately as well as the rate to connect into the existing network. Through the *Local Competition Order*, the FCC was creating rules which will establish rates for these new elements. As a matter of necessity, the FCC had to create a "new" methodology to establish rates for this new service. While Verizon might not agree with the FCC's policy determination in this respect, that disagreement cannot rise to a constitutional confiscation claim unless the overall end result of the FCC's action is unjust and unreasonable.

Verizon duly cites the leading United States Supreme Court and United States Courts of Appeals cases that address confiscation of property in a utility rate setting process. However, Verizon's presentation of the relevant precedent wholly misperceives the nature and effect of those rulings, even beyond the speculation inherent in the Company's claims of confiscation. Whatever Verizon may think of the economic merits of the TELRIC method adopted by the FCC, it is simply impossible, under applicable United States Supreme Court precedent and the facts presented, for Verizon to claim that the FCC's selection of this method, in and of itself, would accomplish an unconstitutional taking.

NASUCA respectfully submits that Verizon's assertions regarding this issue are clearly refuted by the plain language of the *Duquesne* opinion. There is no constitutional prohibition against a regulatory agency adopting a new method of setting utility rates. While the Court observed in *Duquesne* that "a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions," *Duquesne* at 315, that is not what occurred in *Duquesne*, and that is not what occurred here. The Court in *Duquesne* recognized that, "circumstances may

favor the use of one ratemaking procedure over another." *Duquesne* at 316.

The present case does not deal with a situation where the FCC is switching back and forth between methodologies in a manner that is detrimental to the investor interest in every instance. The adoption of TELRIC by the FCC was an economic and policy judgment that the FCC made in order to implement the Congressional directive of the Telecom Act. While Verizon may disagree with the theoretical basis for that determination, it cannot be claimed to have effected an unconstitutional confiscation unless and until the end result of the methodology is shown to have caused substantial financial harm to the utility. There has been absolutely no such showing here.

In support of its argument, Verizon cites the concurrence by Justice Scalia in the *Duquesne* case in stating that for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." Verizon Brief at 28, *quoting*, *Duquesne* at 317 (concurring opinion). The concurring opinion in *Duquesne*, however, is not supportive of Verizon's arguments in this case. In that concurring opinion, Justice Scalia, joined by Justices White and O'Connor, confirmed the basic principle of *Duquesne* that the consequence of regulation, not the technique used, is the critical consideration in determining whether a takings claim can be made. The issue addressed in the *Duquesne* concurrence was whether, for purposes of confiscation analysis, it is necessary to look at all of a utility's "prudent investment" or only the assets that were "used and useful" in serving the public. *Duquesne* at 317. As noted in Justice Scalia's concurring opinion, however, "as the Court's opinion describes, that question is not presented in the present suit which challenges techniques rather than consequences." *Id.*

Challenging techniques, of course, is precisely what Verizon has done in the present appeal. Specifically, it has challenged the "technique" of the FCC's adoption of the TELRIC methodology rather than the consequences. Thus, Verizon's argument fails just as clearly under the concurring opinion in *Duquesne* authored by Justice Scalia as it does under the Court's Opinion authored by Chief Justice Rehnquist.

Verizon has also argued that TELRIC has the effect of "rewriting the terms of thousands of regulatory transactions closed long ago." Verizon Brief at 30. NASUCA submits that this argument too should fail based on the Supreme Court precedent which holds that it is not the method, but the end result which determines whether a taking has occurred. *Supra*. Based on that precedent, Verizon cannot argue that any damage will have occurred to those allegedly "rewritten" transactions until the end result has been reached. NASUCA submits that such end result has not yet been reached.

III. Verizon's Takings Claim is Premature, Speculative and Not Ripe For Review.

A. Verizon Does Not Have a Legitimate Takings Claim Because the Total Effect of The Challenged Order is Not Yet Known.

As argued above, Verizon has failed to set forth the necessary facts to support its takings claim. As a result, its appeal is not ripe for review by this Court. In *FPC v. Texaco Inc.*, 417 U.S. 380 (1974), the Court rejected a facial attack on a proposed method for "indirect regulation" of small gas producers under the Natural Gas Act, and noted:

> Any broadside assertion that indirect regulation will be confiscatory is premature. The consequences of indirect regulation can only be viewed in the entirety of the rate of return allowed on investment, and this effect will be unknown until the Commission has applied its scheme in individual cases over a period of time.

Id. at 392.

This principle was also confirmed in *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974), in which the Court rejected an attack against the area rates established for certain gas producers. In that case, the Court noted that the premise of the arguments -- that certain provisions of the order can be isolated and viewed without regard to the total effect of the order -- was in error. *Id.* at 315. The Court further rejected Mobil's argument that assumed that there was only one just and reasonable rate possible for each vintage of

gas, and that this rate must be based entirely on cost plus a reasonable rate of return. *Id.* at 316.

In *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979), the Court criticized the Court of Appeals in that case for attempting to limit the discretion of the Federal Energy Regulatory Commission (FERC) in setting rates under the Natural Gas Act. While agreeing that the FERC Order, which granted exceptions to area rate levels, had to be remanded, the Court also stated:

> We are also convinced, however, that the Court of Appeals trenched upon the ratemaking authority vested in the Commission when it strongly suggested that the Commission is required to grant the relief Producers request in this case so long as the increase in royalty costs is not imprudent and the relief, when granted, will merely sustain rather than increase Producers' profits.

Id. at 517. The Supreme Court thus flatly rejected the suggestion that a utility is entitled as a matter of constitutional law to recovery of all prudent costs.

These cases uniformly demonstrate the Court's reluctance to find a taking where there is a facial, broadside attack based not upon the end result, but rather upon the possible outcome of ratemaking methodologies not yet applied.

To the extent that Verizon suggests in its brief that it is not claiming an actual taking in this case, but rather is urging a limiting interpretation of the Telecom Act that would prevent such a taking, Verizon Brief at 37, that argument must fail as well. As stated by the D.C. Circuit Court of Appeals in *National Mining Association v.*

Babbitt, 172 F.3d 906 (D.C. Cir. 1999): "We will not 'frustrate[] permissible applications of a statute or regulation,' ... based on the specter -- rather implausible from what we can tell now -- of a future unconstitutional taking." *Id.* at 917 (quoting *United States v. Riverside Bayview Homes*, 474 U.S. 121, 127-28 (1985)).

Here, Verizon's speculative, theoretical claim does not justify a finding that a taking has occurred. Nor does it justify a finding that, absent some limiting ruling by this Court, the FCC Order and the interconnection provisions of the Telecom Act will somehow necessarily result in a future unconstitutional taking of Verizon's property.

B. The FCC Order Under Review Has Not Deprived Verizon of Any of its Property.

In its Order, the FCC fully considered and properly rejected Verizon's confiscation arguments. The FCC methodology is not solely theoretical. Nor did the FCC fail to fully articulate a reasonable basis for its decision.[7] After a voluminous and detailed examination of various considerations advanced by all parties, the FCC concluded that its forward-looking incremental cost standard "is consistent with the Fifth Amendment and is not confiscatory." *Local Competition Order*, 11 F.C.C.R. at 15855, ¶ 701. The

---

[7] In this matter, the FCC's *Local Competition Order* reveals that the FCC clearly considered and rejected Verizon's position after substantial comment and input from a wide range of parties. *Local Competition Order*, 11 F.C.C.R. at 15842-3, 15869-72, ¶¶ 670-671, 733-740. Verizon and other incumbents argued that pricing based on TELRIC would result in an unconstitutional taking of the incumbent's invested capital but that argument was properly rejected.

FCC cited several cases relied upon by Verizon in its present appeal, notably *Hope Natural Gas*, *Permian Basin*, and *Duquesne*. After citing these cases, the FCC noted:

> Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed. Indeed, the Court has found that the "fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid." Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred. Thus, the mere fact an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.

Local Competition Order, 11 F.C.C.R. at 15870-71, ¶ 736 (footnote omitted).

The FCC properly concluded after a full review of the record in its Local Competition proceeding that, "[n]o incumbent LEC has provided persuasive evidence that prices based on forward-looking economic cost methodology would have a significant impact on its 'financial integrity.'" *Id.* at 15871, ¶ 738. In addition, the FCC correctly stated that the end result test considers the "overall

regulatory framework" and whether the incumbent LECs have a reasonable opportunity to recover a return on their investment in light of the revenues from "the incumbent LECs' overall rates.... including the revenues for other services under [the FCC's] jurisdiction." *Id.* at 15871, ¶ 737.[8]

Verizon has not experienced a taking that requires compensation and has not set forth here a claim that is ripe. Verizon has failed to demonstrate that a taking has, in fact, occurred.

[8] The leasing of a local loop to a competitor under the interconnection and UNE provisions of the Telecom Act does not constitute a physical taking without just compensation by obligating the ILEC which owns the loop to lease them to a CLEC. *Qwest Corporation v. United States*, 48 Fed.Cl. 672, 692 (February 20, 2001).

CONCLUSION

For the reasons set forth above, NASUCA submits that the FCC Order here under review cannot be challenged as confiscatory. There has been no showing whatsoever that the Order violates the longstanding test established by the United States Supreme Court for determining whether confiscation has occurred in the ratemaking context. The argument by Verizon that the FCC's use of the TELRIC methodology is unconstitutional must be rejected.

IRWIN A. POPOWSKY
Consumer Advocate of Pennsylvania

Counsel of Record

PHILIP F. MCCLELLAND
Senior Assistant Consumer Advocate

JOEL H. CHESKIS
Assistant Consumer Advocate

National Association of State Utility Consumer Advocates
c/o Pennsylvania Office of Consumer Advocate
555 Walnut Street, 5th Floor
Harrisburg, PA 17101-1923
(717) 783-5048

COUNSEL FOR RESPONDENT
NASUCA

June 8, 2001

(7) (8) (7) (8) (8)

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
JUN - 8 2001
CLERK

JUN 7 2001

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Respondents.

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

---

BRIEF ON THE MERITS OF SPRINT CORPORATION IN OPPOSITION TO PETITIONERS VERIZON COMMUNICATIONS, INC., *ET AL.*

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

52 pp

QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

RULE 29.6 STATEMENT

In accordance with Rule 29.6 of the Rules of this Court, Sprint Corporation ("Sprint") states as follows:

Sprint is a corporation organized for the purpose of engaging in telecommunications and related businesses and is publicly traded under the names Sprint FON and Sprint PCS. Sprint Communications Company L.P. is a wholly-owned subsidiary of Sprint.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
PRELIMINARY STATEMENT	1
STATEMENT OF THE CASE	1
A. Background	1
B. The Act	2
C. The FCC's *Local Competition Order*	5
D. Judicial Review of the *Local Competition Order*	10
1. The First Eighth Circuit Decision	10
2. *IUB I*	10
3. The Eighth Circuit's Decision On Remand (*"IUB II"*)	10
SUMMARY OF ARGUMENT	11
ARGUMENT	15
I. NOTHING IN THE ACT REQUIRES INCORPORATION OF AN ILEC's HISTORICAL COSTS INTO THE RATES FOR UNEs	15
A. Section 252(d)(1) Is Ambiguous And Does Not Require The Use Of Historical Costs In Establishing UNE Rates	15
B. Other Provisions Of The Act Do Not Compel The Use Of Historical Costs For UNE Pricing	20

TABLE OF CONTENTS—Continued

	Page
1. The Act Expresses No Preference For Historical Cost Models And There Is No Reason To Infer One	20
2. The Act's Resale Pricing Provision Does Not Implicitly Endorse Historical Or Forward-Looking Cost Models	24
C. The FCC's Choice Of A Forward-Looking Cost Methodology Was Not Arbitrary Or Capricious And Is Entitled To Deference	24
1. Historical Costs Are Antithetical To The Act's Objectives	25
2. TELRIC Is Not "Unmanageable"	27
3. The FCC Did Not "Abandon" Historical Cost Models	28
II. THE FCC's SELECTION OF THE TELRIC METHODOLOGY DOES NOT VIOLATE THE TAKINGS CLAUSE	28
A. TELRIC Does Not Represent A Constitutionally Suspect Shift In Methodologies	29
B. The ILECs' Theoretical Attacks On TELRIC Are Barred By The Well-Settled "Total Effect" Test For Regulatory Takings	34
C. The Doctrine Of Constitutional Avoidance Does Not Require The Inclusion Of Historical Costs In UNE Prices	39
CONCLUSION	43

TABLE OF AUTHORITIES

CASES	Page
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
American Public Gas Ass'n v. Federal Power Comm'n, 567 F.2d 1016 (D.C. Cir. 1977)	21
American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry., 387 U.S. 397 (1967)	31
Apex Plumbing Supply, Inc. v. U.S. Supply Co., 142 F.3d 188 (4th Cir. 1998)	19
Appalachian Power Co. v. EPA, 135 F.3d 791 (D.C. Cir. 1998)	16
Baltimore & Ohio R.R. v. United States, 345 U.S. 146 (1953)	37
Bell Atl. Tel. Cos. v. FCC, 24 F.3d 1441 (D.C. Cir. 1994)	41
Brooks-Scanlon Co. v. Railroad Comm'n of La., 251 U.S. 396 (1920)	35
Burlington N. R.R. v. Surface Transp. Bd., 114 F.3d 206 (D.C. Cir. 1997)	19
Capital Network Sys., Inc. v. FCC, 28 F.3d 201 (D.C. Cir. 1994)	16
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	12, 25
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	*passim*
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	*passim*
GTE S., Inc. v. Morrison, 6 F. Supp. 2d 517 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999)	20, 22, 23
Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993)	18, 33, 34

TABLE OF AUTHORITIES—Continued

	Page
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	4, 6, 10
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	*passim*
Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987)	38
Market St. Ry. v. Railroad Comm'n of Cal., 324 U.S. 548 (1945)	30, 32
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	17
Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos., 498 U.S. 211 (1991)	17
National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993)	23, 33
New York Cent. R.R. v. White, 243 U.S. 188 (1917)	32, 33
In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	32, 38
Railway Labor Executives' Ass'n v. United States, 987 F.2d 806 (D.C. Cir. 1993)	41
Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc., No. A 97-CA-132 SS, 1998 WL 657717 (W.D. Tex. Aug. 31, 1998)	*passim*
Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118 (1939)	30, 31
Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000)	21, 43

TABLE OF AUTHORITIES—Continued

	Page
Town of Concord v. Boston Edison Co., 915 F.2d 17 (1st Cir. 1990)	26
United States v. Miller, 317 U.S. 369 (1943)	31
United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985)	14, 40
In re Valuation Proceedings Under §§ 303(c) & 306 of the Reg'l Rail Reorg. Act, 439 F. Supp. 1351 (Regional Rail Reorg. Ct. 1977)	37
Williamson County Reg'l Planning Comm'n v. Hamilton Bank, 473 U.S. 172 (1985)	40, 42

AGENCY DECISIONS

Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in Mich., 12 F.C.C.R. 20,543 (1997)	4
In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996)	*passim*
Policy and Rules Concerning Rates for Dominant Carriers, 5 F.C.C.R. 6786 (1990)	22, 23, 33

STATUTES

47 U.S.C. § 201(b)	5
47 U.S.C. § 251(c)(2)	2
47 U.S.C. § 251(c)(3)	3
47 U.S.C. § 251(c)(4)	3
47 U.S.C. § 251(d)(1)	5, 20
47 U.S.C. § 252(b)(4)	22
47 U.S.C. § 252(d)(1)	*passim*
47 U.S.C. § 252(d)(1)(A)(i)	3, 18
47 U.S.C. § 252(d)(1)(B)	3

TABLE OF AUTHORITIES—Continued

	Page
47 U.S.C. § 252(d)(3)	24
47 U.S.C. § 252(e)(6)	39
47 U.S.C. § 254	27, 39
RULES	
47 C.F.R. § 51.505(b)(1) (2000)	2, 6
47 C.F.R. § 51.505(b)(2) (2000)	6
47 C.F.R. § 51.505(b)(3) (2000)	7
47 C.F.R. § 51.505(c) (2000)	7
CONGRESSIONAL MATERIAL	
S Conf. Rep. No. 104-230 (1996)	2
OTHER AUTHORITIES	
Edwin Mansfield, *Microeconomics* (6th ed. 1988)	20
Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* (3d ed. 1994)	17
Laurence H. Tribe, *American Constitutional Law* (2d ed. 1988)	38
Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (1st ed. 1992)	23
Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (2d ed. 1999)	27
Reed E. Hundt, *You Say You Want A Revolution* (2000)	5
Webster's New World Thesaurus (new rev. ed. 1985)	17

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.2 and 25.1, Sprint Corporation ("Sprint") respectfully submits this Respondent's Brief on the Merits in Opposition to Petitioners Verizon Communications, Inc., *et al.* addressing the following question:

> Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 ("Act") requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

Supreme Court Order List (Jan. 22, 2001) at 4.

STATEMENT OF THE CASE

A. Background

Unlike many of the private parties in these proceedings, Sprint has substantial local *and* long distance operations. Sprint has participated both as a new entrant and as an incumbent local exchange carrier ("ILEC") in state-regulated arbitrations pursuant to Section 252 of the Act. These experiences have given Sprint a balanced perspective on the challenges of opening local telephone markets to competition while satisfying the divergent interests of new entrants and ILECs. The "long distance side" of Sprint, like other new entrants, is interested in obtaining access to unbundled network elements ("network elements" or "UNEs") of ILECs at rates and on terms that permit meaningful local competition. The "local side" of Sprint, like other ILECs, is interested in ensuring that it receives just and reasonable compensation for providing UNEs to new entrants.

Sprint believes that the UNE pricing methodology adopted by the Federal Communications Commission ("FCC") strikes the proper balance in implementing the Act's pro-competitive objectives. The FCC established a forward-looking, long-run

methodology for pricing UNEs based on "the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." 47 C.F.R. § 51.505(b)(1) (2000) (FCC Pet. App. 128a).[1] This methodology, which is known generally as "Total Element Long Run Incremental Cost" or "TELRIC," attempts to replicate prices that would prevail in a competitive environment, while ensuring that the ILEC is justly compensated for the use of its network elements at prices reflecting what it would cost to replace the functionalities provided by those elements today.

B. The Act

The Act seeks to transform state-sanctioned local monopolies into fully competitive markets on a national scale. *See* S. Conf. Rep. No. 104-230, at 113 (1996) (the primary goal of the Act is to increase competition in both local and long distance telephone markets as swiftly as possible). Congress recognized the practical and economic impediments that new entrants would face if forced to replicate all of the ILEC's existing local network infrastructure. Congress thus established comprehensive requirements "intended to facilitate market entry." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999) ("*IUB I*"). "Foremost" among them is the ILEC's "obligation under [the Act] to share its network with competitors." *Id.*

Section 251(c) provides three complementary avenues for new entrants to obtain access to an ILEC's network. First, a new entrant may "interconnect" its facilities with an ILEC's existing local network. 47 U.S.C. § 251(c)(2) (FCC Pet. App.

[1] The Court has agreed to the submission of a deferred Joint Appendix. For purposes of this brief, Sprint cites to previously reproduced excerpts from the Petition for a Writ of Certiorari of the FCC and United States of America ("FCC Pet. App. ___") or the Petition for a Writ of Certiorari of WorldCom, Inc. ("WorldCom Pet. App. ____").

106a). This enables the new entrant to transmit and receive calls to and from all local telephone subscribers without replicating an entire telephone network.

Second, a new entrant may purchase an ILEC's retail services at wholesale rates and then resell the services to local customers under the new entrant's brand name. *Id.* § 251(c)(4) (FCC Pet. App. 107a). This enables the new entrant to compete on the basis of price and service, without investing in any of its own facilities.

Third, and most relevant here, a new entrant may lease UNEs from the ILEC. *Id.* § 251(c)(3) (FCC Pet. App. 106a-107a). New entrants may use the leased UNEs, alone or in combination with the new entrant's own network facilities, to offer new and different competitive services. ILECs are to receive "just [and] reasonable" compensation for leasing UNEs, "based on the cost . . . of providing" the element, including a "reasonable profit." *Id.* §§ 251(c)(3), 252(d)(1)(A)(i), (B) (FCC Pet. App. 106a-107a, 119a).

Contrary to the ILECs' assertions, the Act expresses no preference for "facilities-based competition" among these three alternatives. This Court—and the Eighth Circuit—have already rejected that notion. In upholding the FCC's so-called "all elements" rule, which allows competitors to provide local telephone service relying solely on leased UNEs, this Court held that:

> [T]he [FCC] reasonably omitted a facilities-ownership requirement. The 1996 Act imposes no such limitation; if anything, it suggests the opposite, by requiring in § 251(c)(3) that incumbents provide access to "any" requesting carrier. We agree with the [Eighth Circuit] that the [FCC's] refusal to impose a facilities-ownership requirement was proper.

IUB I, 525 U.S. at 392-93. The Eighth Circuit similarly held that:

> [A]fter study, we do not believe that the Act's exclusive goal is facilities-based competition. While Congress may have envisioned facilities-based competition in local telephone markets to occur down the road, Congress clearly included measures in the Act, such as the interconnection, unbundled access, and resale provisions, in order to expedite the introduction of pervasive competition into the local telecommunications industry. Congress recognized that the amount of time and capital investment involved in the construction of a complete local stand-beside telecommunications network are substantial barriers to entry, and thus required incumbent LECs to allow competing carriers to use their networks in order to hasten the influence of competitive forces in the local telephone business.

Iowa Utils. Bd. v. FCC, 120 F.3d 753, 816 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). *Cf. In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996*, 11 F.C.C.R. 15,499, 15,509-10 (¶ 13) (1996) ("*Local Competition Order*") ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.").[2]

[2] The ILECs' contention that Congress valued facilities-based competition over UNE-based competition is also disingenuous. For example, SBC, BellSouth, and Ameritech successfully argued to the FCC that UNE-based competition is the equivalent of facilities-based competition for purposes of meeting the requirements of Section 271(c)(1)(A) ("Presence of a Facilities-Based Competitor") of the Act, which prohibits Bell Operating Companies from offering long distance services in the areas in which they are the incumbent until they have proven that those local markets are effectively open to competition. *Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Servs. in Mich.*, 12 F.C.C.R. 20,543, 20,590-91 (¶¶ 86-87) (1997).

C. The FCC's *Local Competition Order*

Congress expressly authorized the FCC to promulgate rules implementing the Act's pro-competitive requirements and set few limits on the agency's exercise of that authority. 47 U.S.C. §§ 201(b), 251(d)(1) (FCC Pet. App. 108a). As this Court has recognized, the key provisions of the Act are subject to multiple interpretations and Congress was "well aware" that these ambiguities would be resolved by the FCC. *IUB I*, 525 U.S. at 397.[3]

Virtually the entire telecommunications industry participated in the FCC's rulemaking proceedings, which culminated in the *Local Competition Order*. A significant part of these efforts focused on the appropriate compensation that new entrants should pay to lease UNEs from ILECs. Most ILECs favored a pricing methodology that would allow recovery of the "historical costs" of their network elements. *Local Competition Order*, 11 F.C.C.R. at 15,834 (¶ 655) (WorldCom Pet. App. 71a-72a). Most new entrants argued that a forward-looking methodology was necessary to allow competition to develop. *Id.* at 15,821-22 (¶ 635) (WorldCom Pet. App. 54a-56a).

The FCC carefully evaluated the various cost methodologies proposed by the commenters, *id.* at 15,812-72

[3] The ILECs use statements from former FCC Chairman Reed Hundt to assert that the FCC "was dissatisfied with the 1996 Act" and purposely discriminated against the ILECs in favor of new entrants. These *post*-employment statements are irrelevant; they have also been misleadingly selected and quoted out of context. In the same passages cited by the ILECs, the former Chairman emphasized that the FCC "did not want to confer advantage on particular companies." Reed E. Hundt, *You Say You Want A Revolution* 155 (2000). He also noted that the Act produced "a mountain of ambiguity" and that subsequent regulations interpreting these ambiguities may allow new entrants a "fairer chance to compete," consistent with Congress' goal of opening the local telephone market to competition. *See id.* at 154.

(¶¶ 618-740) (WorldCom Pet. App. 42a-126a), and ultimately determined that TELRIC was the most effective and fair means to implement the Act's pro-competitive goals, *id.* at 15,846-47 (¶ 679) (FCC Pet. App. 66a-67a). Based on substantial economic commentary and analysis, the FCC concluded that a forward-looking cost methodology, such as TELRIC, would best replicate the conditions of a competitive market. *Id.* at 15,846-47, 15,857-58 (¶¶ 679, 705) (FCC Pet. App. 66a-67a, 86a-87a). Typically, new firms enter a market and set prices based on the costs of building the most efficient facilities necessary to compete. Incumbents must then respond to those prices, even if their existing facilities are less efficient. *See id.* at 15,846-47 (¶ 679) (FCC Pet. App. 66a-67a). Forward-looking pricing of UNEs helps to achieve a similar result. New entrants cannot immediately compete on equal terms because the costs of entry (*viz.*, replicating a ubiquitous local network) are vastly too prohibitive to be incurred all at once. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 816. A methodology based on forward-looking economic costs helps to "drive retail prices to their competitive levels" by setting costs at levels firms would face in a competitive market. *Local Competition Order*, 11 F.C.C.R. at 15,846 (¶ 679) (FCC Pet. App. 66a). This, in turn, "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." *Id.* at 15,817 (¶ 630) (FCC Pet. App. 55a).

The FCC also took steps to ensure that the TELRIC methodology allows ILECs to recover the full forward-looking cost of leased UNEs, by measuring the long-run, incremental cost of the network element based on: (i) the use of the "most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers," 47 C.F.R. § 51.505(b)(1) (FCC Pet. App. 128a); (ii) the cost of capital, thus allowing ILECs to recover normal economic profit, *id.* § 51.505(b)(2) (FCC Pet. App. 128a);

and (iii) the useful life of the element, as measured by its economic depreciation rate, *id.* § 51.505(b)(3) (FCC Pet. App. 128a). In addition, TELRIC allows for a reasonable share of joint and common costs. *Id.* § 51.505(c) (FCC Pet. App. 129a).

The FCC concluded that TELRIC would not always result in forward-looking costs that are below historical costs. Although the application of TELRIC to certain elements of an ILEC's local telephone network, such as switches and other computer-based components, may result in forward-looking costs below historical costs, the opposite may be true for other elements such as loops, whose costs are driven by material or labor. *Local Competition Order*, 11 F.C.C.R. at 15,857-59 (¶¶ 705, 707) (FCC Pet. App. 86a-88a). At the same time, the FCC determined that an ILEC's existing wire centers should be used as a component of TELRIC, precisely to "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, [would be] able to provide the service at a lower cost than the incumbent LEC." *Id.* at 15,849 (¶ 685) (FCC Pet. App. 71a).

The FCC considered and addressed each of the objections to TELRIC raised by the ILECs. By designing a forward-looking cost methodology that simulates a competitive market, the FCC sought to ensure that the rates eventually produced by TELRIC are properly balanced and enable new entrants to compete for local customers from the outset. *Id.* at 15,848-49 (¶ 685) (FCC Pet. App. 70a-71a). On the one hand, if UNE rates are set below forward-looking costs, new entrants might be deterred from building competing facilities. Moreover, some new entrants might be induced to enter using network elements where it would not otherwise be economically efficient for them to do so. On the other hand, if UNE rates are set too high, which a methodology based on historical or "embedded" costs might produce, competitive entry may never occur. Because the costs of immediately

building a completely ubiquitous local network would be prohibitive for any one firm, most new entrants must rely in part on leased UNEs to provide a full range of local services. Excessive UNE rates would make it impossible for new entrants to price these services at competitive levels, effectively impeding market entry.[4]

The FCC similarly rejected the ILECs' argument that forward-looking costs should be based exclusively on an ILEC's existing network, without regard to available, more efficient substitutes. *Id.* at 15,848 (¶ 684) (FCC Pet. App. 70a). Because this approach would allow ILECs to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* A forward-looking methodology, in contrast, rationally examines what it would cost to replace the functions that make a network asset valuable. This includes currently available substitutes that perform the same functions as the original network element, but embody

[4] The ILECs claim that TELRIC pricing has caused "many entrants" to alter plans "away from deploying competing facilities." Brief for Petitioners ("Pet'r Br.") at 13, 49. This claim is rebutted by FCC data indicating that no single method of competitive entry predominates. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001). The isolated examples they cite to from 1996 fail to demonstrate that TELRIC caused "many new entrants" to halt facilities-based entry. At that time, the FCC's pricing rules were vacated and the individual state commissions were in the process of determining UNE pricing in individual arbitrations. Moreover, a myriad of reasons may explain why a particular company would modify a business strategy away from expending the massive amounts of capital needed for facilities-based entry. For example, a particular new entrant may have difficulty in raising the needed capital. *See* Letter from Chairman Michael Powell to Congress of 5/4/01, at 1. A new entrant may also reasonably wait to invest in facilities until it has reached sufficient scale by servicing customers through resale and UNEs, which in many parts of the country new entrants have failed to reach even today, five years after the Act's passage.

more efficient technologies to do so. *Id.* at 15,848-49 (¶¶ 683-685) (FCC Pet. App. 69a-71a).[5]

The FCC also found that a forward-looking cost methodology would not result in a "taking" of the ILECs' property without just compensation. Under this Court's precedents, the "just and reasonable" standard of the Takings Clause requires, in the regulatory context, an examination of the "total effect" of the actual rates established by the agency. *Id.* at 15,870-71 (¶¶ 734-737) (FCC Pet. App. 92a-94a). After reviewing the record, the FCC found that "[n]o incumbent LEC has provided persuasive evidence that prices based on a forward-looking economic cost methodology would have a significant impact on its 'financial integrity.'" *Id.* at 15,871 (¶ 738) (FCC Pet. App. 95a). Even so, the FCC specifically ordered the ILECs to "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* at 15,872 (¶ 739) (FCC Pet. App. 95a). The FCC also determined that TELRIC is consistent with the "just and reasonable" standard used for takings that result in a physical occupation of property. *Id.* (¶ 740) (FCC Pet. App. 95a-96a).

Finally, the FCC determined that state commissions would be able to implement TELRIC in setting UNE rates. A

[5] The ILECs claim that TELRIC "hypothesizes a fantasy world in which carriers would repeatedly rip out and instantaneously rebuild their entire plant every time a newer technology hits the market or a more efficient configuration could be achieved." Pet'r Br. at 9-10. This assertion is exaggerated. TELRIC rationally measures the cost of providing the actual network element by asking what cost the ILEC or any other carrier would bear in the marketplace, *at the time the UNE rates are established*, to replace the functions of the network element at issue with currently available efficient substitutes consistent with the ILEC's existing wire center. UNE rates are typically in place for the term of an interconnection agreement, which is commonly three to four years, and are not changed "every time a newer technology hits the market."

number of state commissions were already using forward-looking methodologies similar to TELRIC in setting retail rates for local services. *Id.* at 15,817-18, 15,847 (¶¶ 631, 681) (FCC Pet. App. 56a-58a, 67a-68a). As the FCC found, "the record demonstrates that such approaches are practical and implementable." *Id.* at 15,847 (¶ 681) (FCC Pet. App. 68a).

D. Judicial Review of the *Local Competition Order*

1. The First Eighth Circuit Decision

Challenges to the *Local Competition Order* were consolidated in the Eighth Circuit and first decided in 1997. Among other things, the Eighth Circuit invalidated the FCC's pricing rules—including TELRIC—holding that the Act gives state public utility commissions, not the FCC, general jurisdiction to interpret and implement the Act's pricing provisions. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 794.

2. *IUB I*

On review, this Court held, *inter alia*, that Section 201(b) of the Act gives the FCC jurisdiction to adopt rules to implement all of the Act's local competition provisions. *IUB I*, 525 U.S. at 377-86. The Court reversed the Eighth Circuit's ruling that the FCC lacked the statutory authority to establish national pricing rules, reinstated the FCC's pricing rules, and remanded so that the Eighth Circuit could review the substantive challenges to them. *Id.* at 377-78.

3. The Eighth Circuit's Decision On Remand ("*IUB II*")

The Eighth Circuit found that the term "cost" in § 252(d)(1) is "ambiguous" and that the FCC was authorized to interpret the term to allow for a forward-looking cost methodology like TELRIC. *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 751-52 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 11a). The Eighth Circuit further held that the FCC's "use of a

forward-looking cost methodology was reasonable . . . [and] that the FCC explained in detail its reason for selecting [such] a methodology to implement the new competitive goals of the Act." *Id.* at 752 (FCC Pet. App. 12a).[6]

The Eighth Circuit also rejected the ILECs' argument that the doctrine of constitutional avoidance required the FCC to use a historical cost methodology. "[A] takings claim," the court correctly noted, "cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *Id.* at 754 (FCC Pet. App. 17a). Accordingly, the Eighth Circuit held that:

> "It is not enough that a party merely speculates that a government action will cause harm." We do not need to disregard *Chevron* deference and interpret the statute in accordance with the petitioners' views in order to avoid an unconstitutional taking in this instance. The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates have been determined and applied, the constitutional claim is not ripe.

Id. at 754 (citations omitted) (FCC Pet. App. 17a-18a).

SUMMARY OF ARGUMENT

The FCC's choice of the TELRIC methodology is entitled to substantial deference. Under *Chevron*, the agency's decision should be upheld unless "Congress has . . . addressed the precise question at issue" and unambiguously foreclosed

---

[6] The Eighth Circuit's vacation of Rule 505(b)(1) is addressed in Sprint's previously-filed Brief on the Merits in Support of Petitioners Federal Communications Commission and United States of America.

the agency's choice or the agency's reasoning was arbitrary. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43, 845 (1984) ("*Chevron*"). The Act, as this Court found, "is in many important respects a model of ambiguity or indeed even self-contradiction" that imposes few restraints on the FCC's exercise of its implementing authority. *See IUB I*, 525 U.S. at 397 (the Act grants "most promiscuous rights" to the FCC). In applying *Chevron* deference to FCC regulations promulgated under the Act, this Court has held that such regulations should be affirmed unless they exceed the few "clear limits" that the Act contains. *Id.*

The Act does not mandate or prohibit any particular pricing methodology for UNEs. As the Eighth Circuit correctly found, "the term 'cost,' as it is used in [Section 252(d)(1)], is ambiguous and . . . Congress has not spoken directly on the meaning of the word in this context." *IUB II*, 219 F.3d at 751 (FCC Pet. App. 11a). The responsibility for interpreting and implementing that provision thus belongs to the FCC, not the courts. *Id.* at 752 (FCC Pet. App. 12a). The FCC evaluated numerous alternatives, including historical and forward-looking cost methodologies, before determining that TELRIC would best serve the dual goals of fairly compensating ILECs for UNEs while promoting the competitive market conditions desired by Congress. *Local Competition Order*, 11 F.C.C.R. at 15,812-72 (¶¶ 618-740) (WorldCom Pet. App. 42a-126a). The FCC also "explained in detail its reason for selecting a forward-looking cost methodology to implement the new competitive goals of the Act." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The agency's expert judgment to use TELRIC, rather than a methodology that includes historical costs, was well-reasoned, supported by the record, and should be affirmed.

The ILECs assert that TELRIC is an "unmanageable" methodology and that it was arbitrary and capricious for the FCC to adopt it. This claim is readily disproved. In adopting

TELRIC, the FCC found that the methodology was both practical and implementable by the states. These findings have been confirmed by experience, as state commissions around the country have successfully applied TELRIC in establishing UNE rates within the timetables set by the Act. Even after the Eighth Circuit invalidated the FCC's promulgation of TELRIC on jurisdictional grounds, a majority of state commissions adopted the methodology, independently concluding that it best served the goals of fairly compensating ILECs, promoting local competition, and ensuring efficient entry, utilization, and expansion of the telecommunications infrastructure.

The FCC's adoption of the TELRIC methodology does not violate the Fifth Amendment to the United States Constitution. The ILECs wrongly claim that the FCC "shifted" methodologies from a historical to a forward-looking cost methodology and that this "opportunistic switch" results in an uncompensated taking. This argument is based on an analytical artifice that lacks factual and legal foundation. Congress charged the FCC with implementing an entirely new regulatory regime that opens decades-held monopolies to competition. The FCC was not bound by any of the historical and forward-looking cost methodologies used by the agency or the states in establishing rates during the monopoly era. Rather, the FCC was obligated to use its expert judgment in adopting a methodology that both comports with the Act's UNE pricing standards and promotes the pro-competitive goals of Congress. The FCC's adoption of TELRIC helps to implement the new Act and in no way resembles the type of "opportunistic switch" from a settled cost methodology that might raise constitutional concerns under this Court's precedents.

The ILECs' "takings" challenge to the TELRIC methodology itself also fails. A takings claim must be based on an actual rate, not the ratemaking methodology. "It is not theory

but the impact of the rate order which counts." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope Natural Gas*"). As the Eighth Circuit found, the ILECs' takings claim remains purely theoretical. The ILECs presented no credible evidence during the FCC rulemaking that TELRIC prices or the Act's overall pricing scheme would significantly affect their financial integrity. Nor have they provided any persuasive evidence of such effects here. Even if a takings challenge to the TELRIC methodology were ripe, it would still fail. The TELRIC methodology allows ILECs to recover their full forward-looking costs of providing UNEs to new entrants. When properly applied, the methodology comports with the Act's requirement that ILECs receive "just and reasonable" compensation for leasing UNEs. The ILECs are entitled to no more.

Finally, the ILECs wrongly argue that the "constitutional avoidance" doctrine negates *Chevron* deference and requires adoption of a historical cost methodology. Mere allegations that a regulatory program may result in a taking does not justify the use of a narrowing construction which might frustrate a potentially permissible application of a statute. *See United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29 (1985) ("*Riverside Bayview Homes*"). The Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates, thus obviating any basis for a limiting construction. The ILECs have not shown that any actual rates derived from TELRIC are so unjust as to be confiscatory. Their unsubstantiated claims of potential constitutional infirmity provide no basis for this Court to disregard *Chevron* deference in favor of the ILECs' restrictive views of the Act's UNE pricing provisions.

ARGUMENT

I. NOTHING IN THE ACT REQUIRES INCORPORATION OF AN ILEC's HISTORICAL COSTS INTO THE RATES FOR UNEs.

Section 252(d)(1) of the Act requires "just and reasonable" rates for UNEs "based on the cost . . . of providing the . . . network element. . . . and may include a reasonable profit." 47 U.S.C. § 252(d)(1) (FCC Pet. App. 118a-119a). The Eighth Circuit properly determined that Section 252(d)(1) is ambiguous as to the cost methodology that may be employed in establishing UNE rates. *IUB II*, 219 F.3d at 751-53 (FCC Pet. App. 10a-14a). The Eighth Circuit thus upheld the FCC's adoption of a forward-looking cost methodology as a reasonable interpretation of the statute. *Id.* at 752-53 (FCC Pet. App. 11a-14a). The ILECs challenge these holdings, arguing that the "plain text, structure, and purpose of Section 252" demonstrate that Congress unambiguously intended for an ILEC's "historical" costs to be included in the UNE rate methodology. Brief for Petitioners ("Pet'r Br.") at 16, 19-21. These arguments are unpersuasive when measured against the statutory language and scheme.

A. Section 252(d)(1) Is Ambiguous And Does Not Require The Use Of Historical Costs In Establishing UNE Rates.

The ILECs' "plain text" argument relies heavily on various dictionary definitions of "cost" that have little relevance to the term's use in the ratemaking context. According to the ILECs, "cost" simply means the amount paid for an item at the time it was purchased or built. *Id.* at 19. They contend, therefore, that the term "cost," as used in Section 252(d)(1)(A)(i), must include all of an ILEC's past expenditures, *i.e.*, "historical" costs. *Id.* The ILECs also rely on the purported use of the term "cost" in the *pre*-Act monopoly era, arguing that "for decades" the telecom-

munications industry has used the term "cost" to mean "historical" cost and that Congress intended for the term's use in Section 252(d)(1) to be vested with that same meaning. *Id.* at 20.

Contrary to the ILECs' assertions, the term "cost," when used in the regulatory ratemaking context, is susceptible to different meanings and is not confined to a particular dictionary definition. The Act neither defines the term "cost," as used in Section 252(d)(1), nor does it require that UNEs be priced based on any particular cost methodology. As the Eighth Circuit found, "Congress has *not* spoken directly on the meaning of the word in this context. . . . '[T]he word "cost" is a chameleon, capable of taking on different meanings, and shades of meaning, depending on the subject matter and the circumstances of each particular usage.'" *IUB II*, 219 F.3d at 751-52 (emphasis added) (quoting *Strickland v. Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995)) ("the word 'cost' is a chameleon") (FCC Pet. App. 11a); *see Appalachian Power Co. v. EPA*, 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word"). Such an ambiguous term confers, in the words of Justice Breyer, "'broad methodological leeway,'" and "say[s] little about the 'method employed' to determine a particular rate." *IUB I*, 525 U.S. at 423 (citation omitted). The FCC, therefore, properly exercised its authority in interpreting the term to permit a forward-looking cost methodology for establishing UNE rates. *See id.* at 397.[7]

[7] Similarly, the Act's "just and reasonable" pricing provisions are the type of "ambiguous statutory terms" that require "substantial deference to the interpretation the [FCC] accords them." *Capital Network Sys., Inc. v. FCC*, 28 F.3d 201, 204 (D.C. Cir. 1994). Indeed, for more than half a century, the statutory mandate that rates be "just and reasonable" has been understood as granting an agency discretion to choose between a forward-looking and a historical-cost approach. *Hope Natural Gas Co.*, 320 U.S. at 602; *see* Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* § 3.4 (3d ed. 1994) (agency setting "just and reasonable" rates has discretion in selecting rate methodology to comport with statutory policy decisions).

Moreover, Section 252(d)(1) refers to the "cost . . . of *providing*" the UNE to new entrants. This language supports the use of a forward-looking methodology by directing the inquiry to the costs resulting from a new entrant's use of the UNE today, and not what the UNE cost to the ILEC when originally purchased. Any rational firm, including an ILEC, would replace these elements with the most efficient available technologies. *See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 311-12 (1923) (Brandeis, J., concurring) (the proper inquiry "would be, not what it would cost to reproduce the identical property, but what it would cost to establish a plant which could render the service, or in other words, at what cost could an equally efficient substitute be then produced"); *see also Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos.*, 498 U.S. 211, 219 (1991). TELRIC properly sets prices based on the "replacement costs" that firms would currently incur to provide the same UNE functions. This approach properly compensates ILECs for the fair value of the assets they use in "providing" UNEs to new entrants, consistent with the language of Section 252(d)(1).[8]

[8] The ILECs make a weak attempt to distinguish the term "cost" from the term "value." They argue that by compensating ILECs for the replacement cost that would be paid on the open market for the functions of the network element, TELRIC improperly measures "value" not "cost." This purported distinction is overstated. The terms "cost" and "value" are widely recognized as being synonymous. *Webster's New World Thesaurus* 156, 804 (new rev. ed. 1985). The ILECs also ignore the remainder of the statutory language, which requires examination of the "cost . . . of providing" the UNE. This language supports a methodology that looks to the current value of the assets used to provide the UNE functions, for the reasons shown.

Section 252(d)(1) also expressly requires that UNE rates be established "*without reference* to a rate-of-return or other rate-based proceeding . . . ." 47 U.S.C. § 252(d)(1)(A)(i) (emphasis added). Historical costs are invariably determined in a rate-of-return proceeding. *See Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993) ("*Illinois Bell II*"). This statutory language further suggests that Congress did not intend for, let alone mandate that, historical costs be included in UNE prices.

The ILECs also overstate the telecommunications industry's past usage of the term "cost" as requiring a historical cost methodology. Pet'r Br. at 19. Forward-looking cost methodologies have been part of this country's regulatory tradition for over fifty years, and there was a time when this Court believed that the Constitution *mandated* such an approach. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) ("*Duquesne*"). Several states were also implementing forward-looking methodologies to encourage local telephone competition before the Act. *Local Competition Order*, 11 F.C.C.R. at 15,817-18, 15,847 (¶¶ 631, 681) (FCC Pet. App. 56a-58a, 67a-68a). In all events, the FCC was under no obligation to use a particular cost methodology from the *pre*-Act era to implement the pricing provisions of Section 252(d)(1). The Act creates a new regime that fundamentally shifts the provision of local telecommunications services away from the past monopoly environment to a new competitive environment. Congress mandated that new entrants have access to UNEs to compete in the local telecommunications market. The Act did not require the FCC to apply remnants of the old monopoly system to the pricing methodology that it was jurisdictionally authorized to implement, and the FCC found no reasonable basis to do so.[9]

[9] The ILECs wrongly suggest that, because the FCC stated in the entirely different context of cable rate regulation that "'[o]riginal cost is the normal, now traditional method used for public utility rate valuation,'" the agency must use a historical cost methodology here. Pet'r Br. at 20 (citation omitted). In implementing the Cable Act, which is governed by a more traditional ratemaking scheme, the FCC was not attempting to choose the measure of cost best suited to opening a market to competition. The FCC is fully authorized to choose a regulatory tool best suited to one context and a different regulatory tool best suited to a different situation.

Finally, the ILECs argue that Congress "clearly" mandated the use of historical costs because Section 252(d)(1)(B) contains the terms "may include a reasonable profit." The ILECs claim that a "reasonable profit" cannot be realized unless all of an ILEC's historical costs are first recouped. This argument fails for several reasons.

Use of "[t]he word 'may' in a statute normally confers a discretionary power, not a mandatory power." *Apex Plumbing Supply, Inc. v. U.S. Supply Co.*, 142 F.3d 188, 192 (4th Cir. 1998) (citation omitted). Congress thus provided the FCC with discretion to incorporate a "reasonable profit" into the pricing methodology, but did not require the agency to do so.

As the Eighth Circuit also noted, "[a] 'profit' can be made whether a historical cost or forward-looking cost methodology is used." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 13a). The FCC addressed this point during the rulemaking, explaining that "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." *Local Competition Order*, 11 F.C.C.R. at 15,854 (¶ 700) (FCC Pet. App. 81a); *see also Burlington N. R.R. v. Surface Transp. Bd.*, 114 F.3d 206, 210, 212-14 (D.C. Cir. 1997) (rates based on forward-looking costs of "hypothetical 'stand-alone railroad'" provide "a competitive return on all investments the railroad actually made at their current value"). Thus, an ILEC can "obtain a 'reasonable profit' without recovering all of its embedded costs." *Southwestern*

Bell Tel. Co. v. AT&T Communications of the Southwest, Inc., No. A 97-CA-132 SS, 1998 WL 657717, at *11 (W.D. Tex. Aug. 31, 1998) ("*SWBT*"); *see also GTE S., Inc. v. Morrison*, 6 F. Supp. 2d 517, 529 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999) ("*GTE South*").

Lastly, in a competitive environment, market forces drive rates to forward-looking costs. *Local Competition Order*, 11 F.C.C.R. at 15,846 (¶ 679) (FCC Pet. App. 66a-67a). Profits in excess of forward-looking costs are not "normal." Edwin Mansfield, *Microeconomics* 252-53 (6th ed. 1988); *SWBT*, 1998 WL 657717, at *10; *see Local Competition Order*, 11 F.C.C.R. at 15,854-55 (¶ 700) (FCC Pet. App. 81a-82a). By arguing that forward-looking costs do not provide them with a "reasonable profit," the ILECs essentially argue that they are entitled to more profit than is available in either a competitive or a regulated market. While the ILECs may prefer such a windfall, the Act does not *allow*, much less require, it. The FCC was not authorized to include anything more than a "normal" profit in its forward-looking cost methodology. Had the FCC granted ILECs a "supra-normal" profit, as they apparently urge, the agency would have violated the Act's mandate that rates be "reasonable." *Local Competition Order*, 11 F.C.C.R. at 15,855 n.1707 (¶ 700) (FCC Pet. App. 81a-82a).

B. Other Provisions Of The Act Do Not Compel The Use Of Historical Costs For UNE Pricing.

1. The Act Expresses No Preference For Historical Cost Models And There Is No Reason To Infer One.

Congress required the FCC to "complete all actions necessary to establish regulations to implement" the Act within six months. 47 U.S.C. § 251(d)(1) (FCC Pet. App. 108a). From this "congressional desire for swift action," and Section 252(d)(1)'s proscription against the use of "rate-of-

return or other ratemaking proceeding[s]," the ILECs attempt to infer that Congress intended for the term "cost" to mean "already established and readily available" historical costs. Pet'r Br. at 22. This argument rests on the false premise that forward-looking cost models are "novel, complex, and difficult-to-administer," while historical cost models are easy to use and ready off-the-shelf. *Id.*

Modern economic modeling has made forward-looking cost methodologies, in the words of the FCC, both "practical and implementable." *Local Competition Order*, 11 F.C.C.R. at 15,847 (¶ 681) (FCC Pet. App. 67a-68a); *see also American Public Gas Ass'n v. Federal Power Comm'n*, 567 F.2d 1016, 1036-37 (D.C. Cir. 1977) (forward-looking cost methodologies have been routinely used by regulatory agencies to establish rates). Numerous courts and agencies have specifically endorsed forward-looking cost methodologies where the regulatory goal is "to encourage competition." *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12-13 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000) ("*GTE*"). Most experts within and outside the government also agree that a historical cost approach is no less difficult or complex to administer than a forward-looking model. *Local Competition Order*, 11 F.C.C.R. at 15,817, 15,821-22 (¶¶ 630, 635) (FCC Pet. App. 55a-56a).

The notion that the FCC was incapable of evaluating anything but a historical cost methodology during the six-month rulemaking period established by the Act is far-fetched and readily disproved by the administrative record. The FCC evaluated several approaches—including historical and forward-looking cost methodologies—in promulgating implementing regulations for Section 252(d)(1). The *Local Competition Order* contained over 100 paragraphs addressing pricing methodologies and was issued within the six-month

statutory timeframe. *Id.* at 15,812-72 (¶¶ 618-740) (WorldCom Pet. App. 42a-126a).[10] Moreover, the Act contemplated that these new rules, once issued, would be applied by the state commissions to establish actual UNE rates in individual arbitrations over at least another nine-month period. 47 U.S.C. § 252(b)(4) (FCC Pet. App. 117a).

The ILECs' argument also wrongly presumes that state commissions would be incapable of applying anything other than historical cost models in setting UNE rates. This claim similarly is disproved by the record. State commissions have not found TELRIC "novel, complex, and difficult-to-administer." Pet'r Br. at 22. In the five years since the Act's passage, state commissions throughout the country have established UNE rates using TELRIC. *See, e.g., GTE South*, 6 F. Supp. 2d at 526-30; *SWBT*, 1998 WL 657717, at *16 (upholding Texas PUC's use of TELRIC and finding TELRIC "compelled" by the Act). Indeed, many state commissions independently decided to use TELRIC during the period when the FCC's pricing rules were invalidated by the Eighth Circuit on jurisdictional grounds.

Lastly, there is no reason to believe that a historical cost methodology would be easier to apply or would result in more accurate rates than other cost models, as the ILECs wrongly suggest. In 1990, the FCC moved away from traditional cost of service regulation based on historical costs and adopted a "new system" of price cap regulation. *Policy*

[10] The ILECs contend that due process requires "notice and a right to be heard" when a change in rate methodology affects a firm's recovery. Pet'r Br. at 22 n.13, 47. The ILECs received notice of and participated in the proceedings before the FCC, thereby satisfying any purported "due process" concerns. *Local Competition Order*, 11 F.C.C.R. at 15,813 (¶ 622) (FCC Pet. App. 52a-53a) (describing Notice of Proposed Rulemaking requesting comments on the type of pricing methodology for network elements), *id.* at 15,833-35 (¶ 655) (WorldCom Pet. App. 71a-72a) (describing ILECs' argument for the use of historical costs).

and Rules Concerning Rates for Dominant Carriers, 5 F.C.C.R. 6786 (1990). Historical costs, therefore, were not "readily available" to the agency and would have had to be developed essentially from scratch. The historical costs carried on an ILEC's books are not generally allocated to particular categories of network elements. The relevant inputs to historical cost models, therefore, cannot be calculated by simply adding up a series of historical cost figures. The need for economic modeling to determine and verify particular network element prices still exists with the use of historical costs. *GTE South*, 6 F. Supp. 2d at 527 (upholding Virginia commission's refusal to adopt GTE's historical cost model which was labeled a "black box" because its operation and assumptions could not be tested or effectively challenged by others). For these reasons, there is no basis to presume that use of historical costs would be any less difficult or complex to administer than a forward-looking cost model. *See National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993) ("rate of return regulation is costly to administer, as it requires the agency endlessly to calculate and allocate the firm's costs") ("*National Rural Telecom*"). To the contrary, the complexity and unwieldiness of rate-of-return proceedings has led many agencies to abandon historical cost pricing. Regulators have increasingly found forward-looking cost methodologies to be more reliable and practical than historical cost models. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 9.2 (1st ed. 1992) ("In practice, rate of return regulation usually culminates in poor regulation of cost, with prices allowed to float upward."), *id.* § 9.8 ("We now know that by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction.").

2. The Act's Resale Pricing Provision Does Not Implicitly Endorse Historical Or Forward-Looking Cost Models.

The ILECs also wrongly contend that the Act's resale pricing provision, 47 U.S.C. § 252(d)(3), demonstrates a congressional intent to use historical costs to price network elements. Pet'r Br. at 22-23. Section 252(d)(3) requires ILECs to provide their retail services to new entrants at wholesale discounts for resale. The resale price is based on the ILEC's retail tariffs, regardless of how those retail tariffs are set in a particular state. In those states that establish retail tariffs based on forward-looking cost models, the wholesale discount price would reflect that cost methodology. *See Local Competition Order*, 11 F.C.C.R. at 15,957 (¶ 915) (WorldCom Pet. App. 131a). Conversely, in those states that use historic cost methodologies, the wholesale discount price would reflect those models. *Id.* Section 252(d)(3) is thus agnostic as to the cost methodology used by a particular state. Neither Congress nor the FCC expressed any preference for setting wholesale rates based on historical costs.[11]

C. The FCC's Choice Of A Forward-Looking Cost Methodology Was Not Arbitrary Or Capricious And Is Entitled To Deference.

The Eighth Circuit correctly held that the FCC's use of a forward-looking cost methodology was reasonable and well-explained. *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The ILECs dispute the FCC's choice, arguing that: (1) historical costs would be a better measure than forward-looking costs; (2) forward-looking costs methodologies are "unmanageable"; and (3) the FCC failed adequately to explain its reasons for "abandoning" historic costs. Pet'r Br. at 44-49. These

[11] The ILECs' reference to the Act's resale pricing standards is ironic, since they argue elsewhere that their retail rates are often established at prices "substantially *below* cost." *See* Pet'r Br. at 4 (emphasis added).

challenges, at bottom, relate to the wisdom of the FCC's policy decision that a forward-looking cost methodology would better serve Congress' goal of rapid competition than a historical cost model. Under *Chevron*, that policy decision was for the FCC to make. 467 U.S. at 865 ("When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.").

1. Historical Costs Are Antithetical To The Act's Objectives.

The FCC did not exclude historical cost models on a whim. The agency carefully considered the issue and concluded that pricing UNEs based on the historical or "embedded" costs carried on an ILEC's accounting books would be *antithetical* to the pro-competitive goals of the Act. The FCC recognized that these historical costs could be higher or lower than the costs derived from a forward-looking cost model. *Local Competition Order*, 11 F.C.C.R. at 15,857-58 (¶ 705) (FCC Pet. App. 86a-87a). Even so, the FCC reasoned that the use of historical costs in determining the rates paid by new entrants would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the . . . Act." *Id.* at 15,858 (¶ 705) (FCC Pet. App. 87a). Allowing ILECs to price UNEs based on historical costs would force new entrants to price their retail services based on those costs. Because ILECs control the only facilities currently available to provide widescale local service, they could then undercut the prices of any potential competitors. *Id.* at 16,029 (¶ 1065). An incumbent could "set its own rates based on the present value of providing the service"—that is, by writing off obsolete investments just as a competitive firm would—while forcing competitors to "pass along to [their] customers the inflated, monopoly-era

historical costs [the ILEC] seeks to charge new entrants." *SWBT*, 1998 WL 657717, at *13. Forward-looking pricing for network elements, by contrast, places everyone "on a level playing field." *Id.*; *see also Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 18-19 (1st Cir. 1990) (Breyer, J.). As the FCC explained, "[t]he substantial weight of economic commentary in the record suggests that an 'embedded cost'-based pricing methodology would be pro-competitor—in this case the incumbent LEC—rather than pro-competition." *Local Competition Order*, 11 F.C.C.R. at 15,857-58 (¶ 705) (FCC Pet. App. 86a). The FCC thus concluded that historical cost pricing would frustrate the Act's objectives. *Id.* (FCC Pet. App. 86a-87a).

The FCC also built sufficient flexibility into TELRIC to ensure that state commissions account for the effects of competition on ILECs. State commissions must consider these effects in setting the depreciation rates and cost of capital. *Id.* at 15,856 (¶ 702) (FCC Pet. App. 83a-84a). The FCC found that:

> the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate.

Id. (FCC Pet. App. 83a). "States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted." *Id.* Thus, contrary to the ILECs' claims, TELRIC allows state commissions to account for the effects of competition on investment incentives.

2. TELRIC Is Not "Unmanageable."

The ILECs' characterization of TELRIC as "unmanageable" is factually incorrect, Pet'r Br. at 45, for the reasons previously shown. The FCC made a reasoned determination that TELRIC would be "implementable" based on the proven experience of various state commissions. *Local Competition Order*, 11 F.C.C.R. at 15,817-18, 15,847 (¶¶ 631, 681) (FCC Pet. App. 56a-58a, 67a-68a). The practical experience of these state commissions was especially informative because, as the FCC recognized, state commissions would be the ones establishing UNE rates based on the FCC's methodology. *Id.* at 15,847 (¶ 681) (FCC Pet. App. 67a-68a). Virtually every state commission has applied TELRIC in *post*-Act arbitrations, confirming the soundness of the FCC's determination that TELRIC would be manageable to implement. Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.4.4.2 (2d ed. 1999).[12]

---

[12] The ILECs utterly ignore the fact that TELRIC has been successfully implemented by the states and argue instead that TELRIC is an "unmanageable project" based on the FCC's experience in the universal service proceeding. Pet'r Br. at 45; *see also id.* at 12-13. That is not a valid comparison. The states' actual experience with TELRIC is the most relevant inquiry. The FCC's universal proceedings are vastly more complicated than a state commission arbitration to determine UNE prices for an individual ILEC. Congress created a wholesale change in the way universal service would be advanced nationally in the *post*-Act environment. 47 U.S.C. § 254. To implement these requirements, the FCC has conducted a complex, ongoing nationwide proceeding, which involves all state commissions, virtually all local and long distance carriers and other interested parties, and requires the FCC to work with and receive recommendations from a joint federal-state board. *Id.*; *see also* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.5 (2d ed. 1999) ("Perhaps the most daunting task assigned to the [FCC] by the 1996 Act was a thorough review and restructuring of the existing federal universal-service guarantees.").

3. The FCC Did Not "Abandon" Historical Cost Models.

In a final attempt to portray the FCC's rulemaking as "arbitrary and capricious," the ILECs claim that the FCC failed adequately to explain its "decision to abandon historical costs in favor of TELRIC." Pet'r Br. at 46 This claim rests on a false premise. Prior to the Act, ILECs had no obligation to lease UNEs to competitors and the FCC was never called on to establish a cost methodology for UNE access. TELRIC is not an abrupt change from past practices. It is part of the FCC's implementation of an entirely *new* regime. Far from abandoning a settled methodology, the FCC was charged with promulgating a new one that provided just and reasonable compensation while promoting Congress' goal of rapid competition. The FCC fully explained its reasons for selecting a forward-looking cost methodology and for rejecting the use of historical costs. *Local Competition Order*, 11 F.C.C.R. at 15,812-72 (¶¶ 618-740) (WorldCom Pet. App. 42a-126a). It was within the FCC's authority to make these determinations and its selection of TELRIC was not arbitrary or capricious.

II. THE FCC's SELECTION OF THE TELRIC METHODOLOGY DOES NOT VIOLATE THE TAKINGS CLAUSE.

The FCC's decision to exclude historical costs in the UNE rates that ILECs may charge new entrants does not violate the Takings Clause. Pet'r Br. at 24-26. The ILECs construct three arguments in an attempt to implicate constitutional takings principles. They first claim that the FCC's implementation of TELRIC was an "opportunistic switch" from a prior, well-settled historical cost methodology that provided for recovery of past prudent investment. *Id.* at 26-31. They next attack the TELRIC methodology itself, which they contend will force them to lease UNEs to new entrants at

"a loss." *Id.* at 31-42. Finally, they argue that this Court must adopt a narrow construction of Section 252(d)(1)—which, in their view, would require the incorporation of historical costs—in order to avoid "serious constitutional questions" raised by TELRIC. *Id.* at 42-44. None of these claims has merit.

A. TELRIC Does Not Represent A Constitutionally Suspect Shift In Methodologies.

The ILECs wrongly argue that, in adopting TELRIC, the FCC "abandoned the longstanding regime under which incumbents were given the opportunity to recover their actual investment and moved to an extreme version of replacement costs." *Id.* at 26. "This fundamental shift," the ILECs contend, "necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime." *Id.*

The ILECs' attempt to cast TELRIC as a "fundamental switch" in cost methodologies is overstated. The Act does not purport to impose any cost methodology on the states in setting retail rates for an ILEC's traditional local services. Any purported "expectations" the ILECs may have based on the particular methodologies employed by the states for these services—whether they be based on historical or forward-looking costs—are unaffected by the Act. The Act's pricing standards instead apply to an entirely new regime that is designed to open local markets to rapid competition. ILECs had no prior obligation to provide UNEs to new entrants and there was no established methodology for pricing these elements. The TELRIC methodology was chosen by the FCC to implement the Act's pro-competitive requirements. The FCC was not bound by any particular methodology used to set rates in the *pre*-Act monopoly environment in determining how UNEs should be priced in the new competitive environment. Nor did the ILECs have any vested right to

expect that they would be shielded from a methodology based on forward-looking rather than historical costs. As this Court explained decades ago:

> [w]hether competition between utilities shall be prohibited, regulated or forbidden is a matter of state policy. That policy is subject to alteration at the will of the legislature. The declaration of a specific policy creates no vested right to its maintenance in utilities then engaged in the business or thereafter embarking in it.

Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118, 141 (1939) ("*Tennessee Electric*").

The ILECs also wrongly attempt to use *Duquesne* as authority for the proposition that, whenever a regulatory agency adopts a new rate methodology, it must guarantee that the carriers recover "all their previous prudent investment and an appropriate rate of return under the old methodology." Pet'r Br. at 27. Thus, once regulators base rates on historical costs, the ILECs contend, it creates a promise that must be honored under the Constitution. Any change in future rates must provide for recovery of those costs, regardless of the present value of the underlying network assets. *Id.*

Duquesne expressly refutes the ILECs' proposition that recovery of historical costs is constitutionally required. The Takings Clause prevents rates that are "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired." *Duquesne*, 488 U.S. at 307; *see also Market St. Ry. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 567 (1945) (the Takings Clause prevents only "governmental destruction of *existing economic values*" and does not require compensation based on "the present reproduction value of something no one would presently want to reproduce" or the "historical valuation of a property") (emphasis added) ("*Market Street Railway*"). Indeed, prior to *Duquesne*, "it was thought that the Constitution *required*" compensation based on "present value." *Duquesne*, 488 U.S. at 308 (emphasis added). In

Duquesne, this Court explained that the Constitution does not mandate a single theory of valuation, stating, in pertinent part, that:

> [C]ircumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the [regulators] free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

Id. at 316; *see also Hope Natural Gas*, 320 U.S. at 602 (The Takings Clause does not confine regulators "to the use of any single formula or combination of formulae in determining rates."). Under *Duquesne*, therefore, the FCC had broad authority to establish a cost methodology for UNE rates that, in the agency's expert view, "best meets" the objectives of the new Act, regardless of the cost methodologies used by the agency or the states in the *pre*-Act regime.

Even assuming, for argument's sake, that TELRIC represented a "shift" in methodologies, it would not raise a serious constitutional question. As shown, TELRIC provides just compensation to the ILECs by permitting full recovery of the current fair value of the UNEs. The Takings Clause requires no greater compensation, *see United States v. Miller*, 317 U.S. 369, 374 (1943), and the ILECs have no right to expect more. The ILECs acknowledge that the measure for evaluating an alleged property deprivation is the reasonable, investment-backed expectations of the property owner. Pet'r Br. at 29. This Court has repeatedly held that reasonable investors cannot expect an existing ratemaking scheme to be permanent or claim entitlement to particular regulatory treatment. *E.g.*, *Tennessee Electric*, 306 U.S. at 141; *see also American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 397, 416 (1967). *Cf. New York Cent. R.R. v.*

White, 243 U.S. 188, 198 (1917) ("No person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit."). It is thus constitutionally permissible for a regulatory agency to establish new rates based on a changed methodology that excludes historical costs prudently invested. In *Duquesne*, for example, this Court upheld rates that reflected the "current market value" of the utility's investments, even though this approach denied recovery of tens of millions of dollars of prudently incurred historical expenditures. 488 U.S. at 312-14. Similarly, in *Hope Natural Gas*, the Court affirmed the adoption of a new approach for calculating the rate base, even though the resulting rates "might produce only a meager return" on the prior rate base. 320 U.S. at 605. In *Market Street Railway*, the regulatory commission based rates on the present value of a company's assets ($7.95 million), even though the "book value" of the property exceeded $41 million and its "historical reproduction costs" exceeded $25 million. 324 U.S. at 564-68. The Court held that the regulated entity was not constitutionally entitled to compensation based on "the historical valuation of a property whose . . . current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made." *Id.* at 567; *see also In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968) (Courts will not "set aside [a rate order] merely because the [regulatory agency] has on an earlier occasion reached another result.") ("*In re Permian Basin*"). These authorities make clear that the ILECs and their investors had no reasonable basis to "count on" a historical cost methodology "as a necessary component for supplying a constitutional return under the old regime." Pet'r Br. at 30.

Duquesne also establishes that changes in regulatory treatment implicate the Takings Clause only under narrow circumstances; *viz.*, when the state "arbitrarily switch[es] back and forth between methodologies in a way which

require[s] investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." 488 U.S. at 315. The FCC adopted TELRIC to implement the Act's new UNE access requirements. The agency has not arbitrarily switched "back and forth" between cost methodologies and nothing in the record remotely resembles such opportunistic rate manipulation. Moreover, as shown, the FCC had moved away from traditional cost of service regulation based on historical costs in favor of price cap regulation several years before the Act's passage. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990). Price cap regulation establishes rates by considering, among other things, "expected savings from innovation and other economies" that are necessarily "forward-looking." *National Rural Telecom*, 988 F.2d at 178. It is indeed ironic for the ILECs to claim that the FCC's so-called "switch" to TELRIC has a constitutional dimension here, given that they did not challenge the constitutionality of the FCC's "switch" from traditional cost of service regulation to price cap regulation over a decade ago.

In addition to the legal flaws in the ILECs' analysis, their claim that the purported "switch" to TELRIC "wipe[s] out a significant portion of the recovery on past investments" lacks any credible factual basis. The ILECs assert that they have invested $342 billion in their networks over time, based on newly introduced data that they provided to the FCC in a separate, unrelated context. Pet'r Br. at 10-11. Apart from the questionable relevance of these data, they show that approximately $176 billion of that original investment has been *depreciated* on the ILECs' books—a point conveniently missing from the ILECs' analysis. *1999 Statistics of Communications Common Carriers*, table 2.9, at 51 (rel. Aug. 11, 2000). Even under a historical cost methodology, the ILECs' original investment is worth only $166 billion today based on their own data. *Cf. Illinois Bell II*, 988 F.2d at

1258-59 & n.5 ("Since depreciation is an operating cost, investors recover such amounts dollar for dollar.") (citing Breyer & Stewart, *Administrative Law and Regulatory Policy* 237 n.59 (2d ed. 1985)). In comparison, the ILECs contend that TELRIC values those same assets at $180 billion. Pet'r Br. at 10-11. The ILECs' argument that TELRIC "under-values" their networks and "strands" historical costs in a "harshly retroactive" way is thus wholly unsupported.

Although there is no evidence in the record regarding the extent of UNE leasing by new entrants, it is beyond dispute that ILECs continue to control more than 92% of the local markets. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 1 (May 2001). The ILECs, therefore, continue to recover the vast majority of their "historical" network costs through the retail rates established by the state commissions in traditional intrastate rate-of-return proceedings. It seems likely that most, if not all, of an ILEC's undepreciated historical costs existing in 1996 will have been recovered through its retail rates long before any meaningful UNE-based competition takes hold.

B. The ILECs' Theoretical Attacks On TELRIC Are Barred By The Well-Settled "Total Effect" Test For Regulatory Takings.

This Court has held that "[i]t is not theory but the impact of the rate order which counts." *Hope Natural Gas*, 320 U.S. at 602. Accordingly, the Court has rejected theoretical challenges to rate methodologies and examined instead the "total effect" of actual rates for takings purposes. *Id.* An uncompensated taking results only if *application* of the ratemaking methodology produces overall rates so low as to "jeopardize the [regulated entity's] financial integrity . . . either by leaving [it with] insufficient operating capital or by impeding [its] ability to raise future capital." *Duquesne*, 488 U.S. at 312. This "total effect" test is necessary to ensure that

regulators have sufficient methodological leeway to resolve the complicated economic judgments and difficult policy issues involved in setting rates. *Id.* at 314.

The ILECs make no credible attempt to satisfy the "total effect" test in challenging TELRIC. Rather, they contend that the FCC "misapplied" the test "by looking to revenues earned from *all* of an incumbent's operations" in order to "cure" the "below-cost" UNE rates resulting from TELRIC. Pet'r Br. at 32 (emphasis in original). Relying on *Brooks-Scanlon Co. v. Railroad Commission of Louisiana*, 251 U.S. 396, 399 (1920) ("*Brooks-Scanlon*"), the ILECs argue that the FCC may not set "below-cost" rates in one line of business and offset any such deficiency from revenues in a different, unregulated line of business. Pet'r Br. at 33-34.

These arguments mischaracterize the record. TELRIC does not result in "below-cost" rates. As previously shown, TELRIC allows for full recovery of an ILEC's costs plus a reasonable profit, based on a forward-looking methodology. Nor did the FCC "'distort[]' the *Duquesne* 'total effect' test by claiming that it could look to *all* of an incumbent's overall revenues to make up for any deficiency in TELRIC rates," as the ILECs wrongly suggest. *Id.* at 32 (citing *Local Competition Order*, 11 F.C.C.R. at 15,871 (¶ 738) (FCC Pet. App. 94a-95a)) (emphasis in original). The agency explained its analysis as follows:

> In adopting the rules that govern [UNE] rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed. . . . Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in

> the exclusion of historical costs prudently incurred. Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.
>
> Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, *including the revenues for other services under our jurisdiction.*

Local Competition Order, 11 F.C.C.R. at 15,871 (¶¶ 736-737 & n.1756) (emphasis added) (FCC Pet. App. 93a-94a). The record thus shows that the FCC properly analyzed the ILECs' theoretical "taking" claims to TELRIC under this Court's precedents. The FCC did not look to revenues from unregulated segments of the ILECs' businesses, as the ILECs claim, but rather expressly confined its analysis to whether the "end result of [the agency's] overall regulatory framework" provided for just compensation, including the ILECs' revenues from other services expressly under the FCC's jurisdiction.[13]

Based on the evidence before it, the FCC concluded that TELRIC "should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost methodology enables incumbent LECs to recover a fair return

[13] The above-cited record also shows that the FCC properly looked to this Court's precedents on just compensation, and did not attempt to interpret on its own "what costs the Constitution requires" to be recovered—as the ILECs wrongly suggest. Pet'r Br. at 25-26. The Court should reject the ILECs' attempt to parlay this fictitious argument into another ground for negating *Chevron* deference to the FCC's interpretation of "cost" in Section 252(d)(1).

on their investment, *i.e.*, just and reasonable rates." *Id.* (¶ 738) (FCC Pet. App. 94a-95a). Even so, the FCC ordered that ILECs "may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* at 15,872 (¶ 739) (FCC Pet. App. 95a).

The ILECs' reliance on *Brooks-Scanlon* is thus misplaced. In *Brooks-Scanlon*, this Court held that the regulatory agency could not look to the profits earned by a railway company in a separate, unregulated lumber business to subsidize losses being incurred by the company in a regulated, unprofitable rail line. 251 U.S. at 399. As shown, the FCC based its analysis on the markets it regulates, not on any unregulated businesses of the ILECs. *Brooks-Scanlon* was also decided before this Court adopted the "total effect" test. Subsequent decisions have held that *Brooks-Scanlon* in no way precludes an agency from considering revenues from all parts of an entity's regulated business when applying the test. *See, e.g., Baltimore & Ohio R.R. v. United States*, 345 U.S. 146, 150 (1953); *In re Valuation Proceedings Under §§ 303(c) & 306 of the Reg'l Rail Reorg. Act*, 439 F. Supp. 1351, 1357 n.12 (Regional Rail Reorg. Ct. 1977).

Rather than coming forward with any specific information to prove a confiscatory rate, the ILECs have attempted instead to rewrite this Court's regulatory takings jurisprudence. In so doing, the ILECs have turned *Duquesne* on its head. As shown, *Duquesne* holds that there is no single rate methodology mandated by the Constitution and that it is constitutionally permissible for a ratemaker to change methodologies, even where doing so excludes historical costs prudently invested. The ILECs argue just the opposite here, stating that:

> [t]he FCC thus failed to conduct the inquiry *demanded* by *Duquesne*—whether TELRIC rates for UNEs will

> preserve incumbents' opportunity to recover their past prudent investment.

Pet'r Br. at 37 (emphasis added). This assertion demonstrates that it is the ILECs—not the FCC—that have misapplied *Duquesne*.

The ILECs' attempt to avoid the "total effect" test is not surprising, since "[o]nly the most egregiously confiscatory rate structure would have difficulty meeting" the "total effect" test reaffirmed there. Laurence H. Tribe, *American Constitutional Law* § 9-3 n.3 (2d ed. 1988). A utility thus bears a heavy burden in proving that rates are confiscatory under this standard. *In re Permian Basin*, 390 U.S. at 767. The ILECs failed to meet that burden before the FCC, *Local Competition Order*, 11 F.C.C.R. 15,871 (¶ 738) (FCC Pet. App. 95a), and they have failed to meet it here. Although they broadly assert in their merits brief that state commissions "applying TELRIC . . . typically produced discounts of 50% below historical cost," this "evidence" is based on the self-serving testimony of a single witness in an arbitration. The ILECs' claim that TELRIC leaves billions in network costs "stranded" is also belied by their own data, as shown *supra* pp. 33-34. These claims fail to demonstrate that the "total effect" of the FCC's pricing rules is so unjust as to be confiscatory. The ILECs have not shown that they are unable to maintain their financial integrity or to attract necessary capital as a result of TELRIC or the Act's overall pricing scheme. *See Duquesne*, 488 U.S. at 312; *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc).[14] Nor have they attempted to account for the

[14] To the contrary, the ILECs' stock values have appreciated substantially since August 8, 1996, the date the FCC released its *Local Competition Order*. *See* Yahoo Finance Historical Quotes, *available at* http://chart.yahoo.com/d (providing split-adjusted historical stock data showing that from August 8, 1996 to June 1, 2001 stock prices for (i) BellSouth rose from $19.11 per share to $40.56 per share; (ii) SBC rose from $22.12 per share to $42.05 per share; and (iii) GTE/Verizon rose from $25.82 per share to $54.74 per share).

substantial new sources of revenue that the Act now makes available to them by, among other things, allowing them access to the various long distance and other markets foreclosed by the AT&T consent decree. The ILECs' failure to come forward with any such evidence, five years after the Act was adopted, leaves no doubt that their "constitutional" challenge to TELRIC is not really based on takings principles, but rather on the policy choices properly made by the FCC.[15]

Finally, rejection of the ILECs' theoretical challenges to the TELRIC methodology will not foreclose judicial review of whether TELRIC-derived rates are themselves "confiscatory." Pet'r Br. at 40. *Duquesne* explicitly holds that a takings challenge must be based on the effect of a rate, not the methodology employed. The Act authorizes state commissions to conduct arbitrations to establish UNE rates and provides an avenue for judicial review of those determinations. 47 U.S.C. § 252(e)(6) (FCC Pet. App. 122a). As much as the ILECs may prefer to challenge the constitutionality of the FCC's methodology in this proceeding, such a challenge can only proceed after the UNE rates that are a product of that methodology have been set and the effect of those rates can be tested.

C. The Doctrine Of Constitutional Avoidance Does Not Require The Inclusion Of Historical Costs In UNE Prices.

Having constructed their theoretical "takings" challenge to TELRIC, the ILECs next argue that the doctrine of

[15] The fact that the FCC has not concluded its Universal Service Order ("USO") proceedings does not save the ILECs' "takings" claim. The ILECs receive explicit universal service support, as well as compensation from the Act's other pricing provisions. 47 U.S.C. § 254.

"constitutional avoidance" negates *Chevron* deference and requires this Court to interpret Section 252(d)(1) in a way that avoids raising "serious constitutional questions." Pet'r Br. at 42. These questions can only be avoided, the ILECs contend, by interpreting the statute their way; *viz.*, to include historical costs. The Eighth Circuit correctly rejected this argument. *IUB II*, 219 F.3d at 754 (FCC Pet. App. 16a-18a). This Court should do the same.

The doctrine of constitutional avoidance is inapplicable in these circumstances because the Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates. The Fifth Amendment does not proscribe the taking of property. "[I]t proscribes the taking of property without just compensation." *Williamson County Reg'l Planning Comm'n v. Hamilton Bank*, 473 U.S. 172, 194 (1985) ("*Williamson County*"). The Fifth Amendment requires only that an adequate mechanism for compensation exist. *Id.*

A narrowing construction of a statute to avoid a constitutional problem need only be invoked in those cases in which the application of a statute will necessarily constitute a taking and no means of compensation exists. Thus, in *Riverside Bayview Homes*, this Court did not invoke the doctrine of constitutional avoidance because (1) the regulation did not necessarily constitute a taking, and (2) even if it did, a mechanism for compensation existed via the Tucker Act. The Court explained that, as long as compensation is available for those whose property is in fact taken, the government action is not unconstitutional. Because the availability of compensation negates any constitutional concerns, "adoption of a narrowing construction does not constitute an avoidance of a constitutional difficulty, it merely frustrates permissible applications of a statute or regulation." *Riverside Bayview Homes*, 474 U.S. at 128. As this Court explained,

> the possibility that the application of a regulatory program may in some instances result in the taking of individual pieces of property is no justification for the use of narrowing constructions to curtail the program if compensation will in any event be available in those cases where a taking has occurred.

Id.[16] *See also Railway Labor Executives' Ass'n v. United States*, 987 F.2d 806, 816 (D.C. Cir. 1993) ("Because just compensation is presumptively available under the Tucker Act, there is neither an unconstitutional result nor a constitutional doubt to be averted by interpretation.").

Just as the Tucker Act provided a means for compensation in the *Riverside Bayview Homes* and *Railway Labor* cases, and thereby removed the need for a limiting construction of the statutes at issue, the UNE compensation provisions of Section 252(d)(1) remove the need for any limiting construction of the statute to "avoid" a constitutional problem here. As the ILECs concede, the Act embodies the constitutional standard for just compensation. Their real argument

---

[16] Contrary to the ILECs' assertion, it was appropriate for both the FCC and the Eighth Circuit to rely on *Riverside Bayview Homes* as support for the argument that a limiting construction of the Act is not warranted. The ILECs criticize the FCC and the Eighth Circuit for supposedly reading *Riverside Bayview Homes* to establish a general exemption from the principle of constitutional avoidance when the issue involves the Takings Clause. Pet'r Br. at 43-44. Neither the FCC nor the Eighth Circuit even suggested that *Riverside Bayview Homes* stands for that proposition. Rather, the case stands for the principle that the doctrine of constitutional avoidance should only be invoked when a taking necessarily occurs and there is no means available for compensation. When that principle is applied in this case, it is clear that a narrowing interpretation is not warranted. By contrast, in *Bell Atlantic Telephone Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994), a *pre*-Act case that, like *Riverside Bayview Homes*, involved the doctrine of constitutional avoidance, the D.C. Circuit applied a limiting construction to the Communications Act and vacated FCC regulations that required local exchange carriers to provide physical collocation because the Communications Act did not expressly authorize such a taking or provide a compensation mechanism for it. *Id.* at 1445.

is with the FCC's choice of TELRIC to provide it. The FCC was authorized to adopt a forward-looking cost model. That choice—even if deemed a "switch" in methodologies, as the ILECs contend—allows for adequate recovery by ILECs of their costs of providing UNEs to new entrants. TELRIC is thus consistent with the requirements of Section 252(d)(1) and the Takings Clause.

Moreover, as shown, an agency's choice between prudent-investment, historical cost, forward-looking cost, and replacement cost methodologies does not raise constitutional questions *per se*. Each method may provide just compensation when reasonably applied. Conversely, each method could result in unjust rates if misapplied. For these reasons, courts require financial data showing the actual effect of rates —not abstract methodological challenges—when evaluating a takings claim. The ILECs' takings claim is based solely on the choice of methodology made by the FCC and not on any credible evidence that TELRIC-derived rates are confiscatory.

The FCC has also ordered the ILECs to seek relief from the agency should they have credible evidence that TELRIC, "as applied to them, will result in confiscatory rates." *Local Competition Order*, 11 F.C.C.R. at 15,872 (¶ 739) (FCC Pet. App. 95a). The ILECs have yet to avail themselves of that remedy, which itself forecloses a takings challenge at this time. *See Williamson County*, 473 U.S. at 194-96.

Finally, TELRIC is not a "novel" methodology that tests "the outer limits of Congress' power," as the ILECs attempt to suggest. Pet'r Br. at 43. Forward-looking cost methodologies like TELRIC have been widely accepted in the professional literature, were implemented by several state utility commissions prior to passage of the Act, *see Local Competition Order*, 11 F.C.C.R. at 15,817-19 & nn.1508-14 (¶ 631) (FCC Pet. App. 56a-58a), and have already passed

constitutional muster, *see GTE*, 183 F.3d at 411-13 & nn. 12-13.

Under these circumstances, adoption of a narrowing construction of Section 252(d)(1) would not "avoid" any serious constitutional question. It would instead frustrate the FCC's lawful interpretation of the provision to implement the Act's pro-competitive objectives. As the Eighth Circuit correctly found, there is no "need to disregard *Chevron* deference and interpret the statute in accordance with the [ILECs'] views in order to avoid an unconstitutional taking in this instance." *IUB II*, 219 F.3d at 754.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court affirm the FCC's UNE pricing rules in all respects.

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent
Sprint Corporation

JUN 8 2001

Supreme Court, U.S.
FILED
JUN 8 2001
CLERK

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENTS FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES

BARBARA D. UNDERWOOD
Acting Solicitor General
Counsel of Record

JOHN M. NANNES
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

BARBARA MCDOWELL
Assistant to the Solicitor General

CATHERINE G. O'SULLIVAN
NANCY C. GARRISON
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

JOHN E. INGLE
Deputy Associate General Counsel

LAURENCE N. BOURNE
Counsel
Federal Communications Commission
Washington, D.C. 20554

QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutory provisions involved	1
Statement	1
Summary of argument	12
Argument:	
I. The FCC reasonably construed Section 252(d)(1) of the 1996 Act to permit the use of forward-looking costs to determine network elements prices	16
A. The FCC's construction of "cost" is consistent with the language, structure, and purposes of the Act	16
B. The principle of constitutional avoidance does does not require that "cost" be construed as historical cost	26
II. The FCC reasonably determined that a forward-looking cost methodology most effectively implements the competitive objectives of the 1996 Act and is administratively workable	41
Conclusion	50

TABLE OF AUTHORITIES

Cases:

AT&T v. *FCC*, 220 F.3d 607 (D.C. Cir. 2000)	32
AT&T v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999)	2, 4, 8, 16, 19, 35, 45, 47
Alabama Elec. Coop., Inc. v. *FERC*, 684 F.2d 20 (D.C. Cir. 1982)	19
Baltimore & Ohio R.R. v. *United States*, 345 U.S. 146 (1953)	34
Bell Atl.-Del, Inc. v. *McMahon*, 80 F. Supp. 2d 218 (D. Del. 2000)	21

Cases—Continued: Page

BellSouth Corp. v. *FCC*, 162 F.3d 678 (D.C. Cir. 1998) 4, 32
Broad River Power Co. v. *South Carolina*, 281 U.S. 537 (1930) 34
Brooks-Scanlon Co. v. *Railroad Comm'n*, 251 U.S. 396 (1920) 33, 34
Burlington N. R.R. v. *Surface Transp. Bd.*, 114 F.3d 206 (D.C. Cir. 1997) 20
Chevron U.S.A. Inc. v. *NRDC, Inc.*, 467 U.S. 837 (1984) 9, 12, 18, 47
City of Los Angeles Dep't of Airports v. *United States Dep't of Transp.*, 103 F.3d 1027 (D.C. Cir. 1997) 20
Colorado Springs Prod. Credit Ass'n v. *Farm Credit Admin.*, 967 F.2d 648 (D.C. Cir. 1992) 32
Competitive Telecomms. Ass'n v. *FCC*, 117 F.3d 1068 (8th Cir. 1997) 38
Duquesne Light Co. v. *Barasch*, 488 U.S. 299 (1989) 13, 17, 28, 29, 30, 46, 48
FERC v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979) 28
Farmers Union Cent. Exch., Inc. v. *FERC*, 734 F.2d 1486 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984) 42
Federal Power Comm'n v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) 27, 28, 29, 46
GTE S. Inc. v. *Morrison*, 6 F. Supp. 2d 517 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733 (4th Cir. 1999) 21
General Tel. Co. of the S.W. v. *United States*, 449 F.2d 846 (5th Cir. 1971) 30
Iowa Utils. Bd. v. *FCC*, 120 F.2d 753 (8th Cir. 1997), aff'd in part and rev'd in part, 525 U.S. 366 (1999) 7-8, 45
Lucas v. *South Carolina Coastal Council*, 505 U.S. 1003 (1992) 30

Cases—Continued: Page

MCI Communications Corp. v. *AT&T*, 708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983) 17, 18, 42
Market St. Ry. v. *Railroad Comm'n*, 324 U.S. 548 (1945) 28
Missouri ex rel. Southwestern Bell Tel. Co. v. *Public Serv. Comm'n*, 262 U.S. 276 (1923) 49
Mobil Oil Exploration & Producing S.E., Inc. v. *United Distribution Cos.*, 498 U.S. 211 (1991) 20
National Ass'n of Greeting Card Publishers v. *United States Postal Serv.*, 462 U.S. 810 (1983) 19
National Mining Ass'n v. *Babbitt*, 172 F.3d 906 (D.C. Cir. 1999) 27
National Rural Telecom Ass'n v. *FCC*, 988 F.2d 174 (D.C. Cir. 1993) 31, 48, 49
Potomac Elec. Power Co. v. *ICC*, 744 F.2d 185 (D.C. Cir. 1984) 20
Public Citizen v. *United States Dep't of Justice*, 491 U.S. 440 (1989) 40
Reno v. *Flores*, 507 U.S. 292 (1993) 40
Smith v. *Illinois Bell Tel. Co.*, 282 U.S. 133 (1930) 34, 35
Smyth v. *Ames*, 169 U.S. 466 (1898) 19, 46
Southwestern Bell Tel. Co. v. *FCC*, 153 F.3d 523 (8th Cir. 1998) 37, 44
Strickland v. *Commissioner, Me. Dep't of Human Servs.*, 48 F.3d 12 (1st Cir.), cert. denied, 516 U.S. 850 (1995) 18
Texas Office of Pub. Util. Counsel v. *FCC*, 183 F.3d 393 (5th Cir. 1999), cert. granted *sub nom. GTE Serv. Corp.* v. *FCC*, 530 U.S. 1213, cert. dismissed, 121 S. Ct. 423 (2000) 10, 11, 40
Time Warner Entm't Co. v. *FCC*, 56 F.3d 151 (D.C. Cir. 1995), cert. denied, 516 U.S. 1112 (1996) 44
USTA v. *FCC*, 188 F.3d 521 (D.C. Cir. 1999) 44

Cases—Continued: Page

United States v. *564.54 Acres of Land*, 441 U.S 506 (1979) 35
United States v. *Miller*, 317 U.S. 369 (1943) 35
United States v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985) 10, 27
United States v. *Security Indus. Bank*, 459 U.S. 70 (1982) 27
Valuation Proceedings Under Sections 303(c) and 306 of the Reg'l Rail Reorganization Act, In re, 493 F. Supp. 1351 (Spec. Ct. 1977) 34

Constitution, statutes and regulations:

U.S. Const. Amend. V (Takings Clause) ..... *passim*
Administrative Procedure Act, 5 U.S.C. 701 *et seq.* 14, 41
Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ..... 1, 2
Title I, 110 Stat. 61:
47 U.S.C. 153(29) (Supp. IV 1998) 3, 24
47 U.S.C. 251-253 (Supp. IV 1998) 2
47 U.S.C. 251 (Supp. IV 1998) 7, 8, 32, 40
47 U.S.C. 251(c)(2) (Supp. IV 1998) 3
47 U.S.C. 251(c)(2)-(4) (Supp. IV 1998) 3
47 U.S.C. 251(c)(3) (Supp. IV 1998) 3, 10, 41, 44
47 U.S.C. 251(c)(4) (Supp. IV 1998) 24, 25, 44
47 U.S.C. 251(c)(4)(B) (Supp. IV 1998) 26
47 U.S.C. 251(d)(2) (Supp. IV 1998) 3, 8, 41, 44
47 U.S.C. 251(d)(2)(A) (Supp. IV 1998) 3
47 U.S.C. 251(d)(2)(B) (Supp. IV 1998) 3
47 U.S.C. 252 (Supp. IV 1998) 7, 8, 32, 40, 48
47 U.S.C. 252(c)(2) (Supp. IV 1998) 11, 48
47 U.S.C. 252(c)(3) (Supp. IV 1998) 11
47 U.S.C. 252(d)(1) (Supp. IV 1998) ..... *passim*
47 U.S.C. 252(d)(1)(A) (Supp. IV 1998) 4, 11, 16
47 U.S.C. 252(d)(1)(A)(i) (Supp. IV 1998) 24
47 U.S.C. 252(d)(1)(B) (Supp. IV 1998) 4, 12, 22, 23

Statutes and regulations—Continued: Page

47 U.S.C. 252(d)(3) (Supp. IV 1998) 24, 25
47 U.S.C. 252(e)(5) (Supp. IV 1998) 4
47 U.S.C. 254 (Supp. IV 1998) 10, 11, 40
47 U.S.C. 254(a)(2) (Supp. IV 1998) 48
47 U.S.C. 254(e) (Supp. IV 1998) 48
47 U.S.C. 271 (Supp. IV 1998) 32
Title VI, § 601(a)(2), 110 Stat. 143 ..... 4, 32
47 U.S.C. 543(b) 44
47 C.F.R.:
Section 51.315(b) 7
Section 51.315(c)-(f) 7
Section 51.505(b)(1) 9

Miscellaneous:

Access Charge Reform, First Report and Order, In re, 12 F.C.C.R. 15,982 (1997) 43-44
Access Charge Reform, Sixth Report and Order, F.C.C. No. 00-193 (May 31, 2000) 31
Application of Verizon New England, Inc., et al. For Authorization To Provide In-Region, Inter-LATA Servs. in Massachusetts (CC Docket No. 01-9), FCC 01-130 (Apr. 16, 2001), appeal pending *sub nom. WorldCom, Inc.* v. *FCC*, No. 01-1198 (D.C. Cir. filed Apr. 25, 2001) 32
Harvey Averch & Leland L. Johnson, *Behavior Of The Firm Under Regulatory Constraint*, 52 Am. Econ. Rev. 1052 (1962) 49
William J. Baumol & Thomas W. Merrill:
Deregulatory Takings, Breach Of The Regulatory Contract, And The Telecommunications Act of 1996, 72 N.Y.U. L. Rev. 1037 (1997) 46
Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Services To Rivals, 73 N.Y.U. L. Rev. 1122 (1998) 46
1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent LECs, In re, 15 F.C.C.R. 242 (1999) 38

Miscellaneous—Continued: Page

James C. Bonbright et al., *Principles of Public Utility Rates* (2d ed. 1988) 19
20 C.J.S. *Costs* (1940) 18
Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* (2d ed. 1994) 45
Jim Chen, *The Second Coming of Smyth* v. *Ames*, 77 Tex. L. Rev. 1535 (1999) 32-33, 46, 47
Commission Recommendation on Interconnection in a Liberalised Telecommunications Market (Pt. 1, Interconnection Pricing), O.J. 1998 L073/42 21
Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide* (ICC Feb. 8, 1983) 20
Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), aff'd *sub nom. Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444 (3d Cir. 1987) 20
Federal-State Joint Bd. on Universal Serv., Recommended Decision, In re, 12 F.C.C.R. 87 (1996) 49
Federal-State Joint Bd. on Universal Serv., Report and Order, In re, 12 F.C.C. 8776 (1997) 10, 49
Federal-State Joint Bd. on Universal Serv., Tenth Tenth Report and Order, In re, 14 F.C.C.R. 20,156 (1999) 38
Federal-State Joint Bd. on Universal Serv., Ninth Report and Order and Eighteenth Order on Reconsideration, In re, 14 F.C.C.R. 20,432 (1999) 37
David Gabel & David I. Rosenbaum, *Who's Taking Whom: Some Comments And Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239 (2000) 38, 46, 48
Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999) 32, 39, 40, 46

Miscellaneous—Continued: Page

Peter W. Huber, Michael K. Kellogg & John Thorne, *Federal Telecommunications Law* (2d ed. 1999) 21
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, In re, 11 F.C.C.R. 15,499 (1996) ..... *passim*
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (1999), petitions for review pending *sub nom. United States Telecomm. Ass'n* v. *FCC*, Nos. 00-1015 et al. (D.C. Cir. Jan. 19, 2000) 8
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 (CC Docket No. 96-98), FCC 00-183 (June 2, 2000), petition for review pending *sub nom. Competitive Telecomms. Ass'n* v. *FCC*, No. 00-1272 (D.C. Cir. June 23, 2000) 38
Industry Analysis Division, FCC:
Local Telephone Competition at the New Millennium (2000) 2
Local Telephone Competition: Status as of June 30, 2000 (2000) 1-2, 45
Interstate Rate of Return Summary (FCC Apr. 10, 2001) 29
Interstate Rate of Return Summary, Years 1991 Through 2000 (FCC May 3, 2001) 29
Hank Intven, Jeremy Oliver & Edgardo Sepulveda, *Telecommunications Regulation Handbook* (2000) 21, 22
Jean-Jacques Laffont & Jean Tirole, *Competition In Telecommunications* (2000) 49
Richard J. Pierce, Jr., *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?*, 77 Geo. L.J. 2031 (1989) 19-20
Jim Rossi, *The Irony Of Deregulatory Takings*, 77 Tex. L. Rev. 297 (1998) 46

Miscellaneous—Continued: Page

Paul A. Samuelson & William D. Nordhaus, *Economics* (16th ed. 1998) 43
Seth Schiesel, *No End to Upheaval in Telecom Industry*, N.Y. Times, Dec. 18, 2000 29

OPINIONS BELOW

The opinion of the court of appeals (No. 00-587 Pet. App. 1a-43a) is reported at 219 F.3d 744. The *Local Competition Order* of the Federal Communications Commission (FCC) is reported at 11 F.C.C.R. 19,392.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. Verizon's petition for a writ of certiorari in No. 00-511 was filed on October 4, 2000, and was granted on January 22, 2001. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56, are reproduced in the appendix to our petition in No. 00-587 (U.S. Pet. App.) 104a-125a and in the Joint Appendix (J.A.) at 9-48. In referring to the provisions of the 1996 Act, we have cited the 1998 Supplement to the United States Code.

STATEMENT

1. a. Throughout most of the United States, local telephone service in each community has long been dominated by a single incumbent "local exchange carrier," or LEC. That incumbent LEC, whether a regional Bell company or an independent carrier, owns almost all of the loops (the wires that connect telephones to switches) in its service area, along with the switches (which direct calls to their destinations) and the transport trunks (which carry calls between switches). The incumbents' control over those facilities has solidified their de facto monopoly position in most local telecommunications markets. Indeed, even today, after years of efforts to open those markets to competition, incumbents still provide service over approximately 93% of local telephone lines. See Industry Analysis Division, FCC,

Local Telephone Competition: Status as of June 30, 2000, at 1 (2000); see also Industry Analysis Division, FCC, *Local Telephone Competition at the New Millennium*, Table 6 (2000) (as of December 1999, incumbents controlled approximately 94% of total local telecommunications revenues).

The barriers to entry into local telecommunications markets are different from, and vastly more formidable than, the barriers to entry into the long-distance market. It has been economically practicable for some long-distance carriers to build their own interexchange infrastructure—*e.g.*, to lay cable or build microwave networks connecting local calling areas to one another—because they can rely (albeit at a cost) on the LECs on either end of an interexchange call to route the call through the various switches and local loops from the call's origin to its destination. But, at least with current technology, it would be economically impracticable for even the largest prospective competitor to duplicate completely the functions of an incumbent LEC's entire network. And, without rights of interconnection, a potential competitor could not gradually enter the market through partial duplication of those functions; a new carrier would win few customers if its customers could call only one another and not customers on the incumbent LEC's separate (and completed) network.

b. "Until the 1990's, local phone service was thought to be a natural monopoly. * * * Technological advances, however, have made competition among multiple providers of local service seem possible." *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 371 (1999). Congress enacted the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56, to open local telecommunications markets to full competition. Congress recognized that no prospective entrant could replicate, at least in the short term, all of an incumbent's existing local network infrastructure. Accordingly, in the local competition provisions of the 1996 Act, 47 U.S.C. 251-253, Congress provided the means for potential competitors to enter local markets by using the incumbents' networks in a variety of ways. See 47 U.S.C. 251(c)(2)-(4).

Central to the local competition provisions is Section 251(c)(3), which entitles a new entrant to gain "access" to (*i.e.*, to lease) an incumbent's "network elements," such as loops, switching capability, and other components and capabilities of the incumbent's network. 47 U.S.C. 251(c)(3); see also 47 U.S.C. 153(29) (defining "network element"). That provision permits new entrants, some of which may also have network elements of their own, to lease from an incumbent those elements that they need to provide services to their own customers.[1] The 1996 Act further permits new entrants to "interconnect" their own facilities with those in the incumbent's network "at any technically feasible point." See 47 U.S.C. 251(c)(2).

An incumbent may charge a new entrant for interconnection and access to network elements. If the incumbent and the new entrant cannot agree on those charges, the 1996 Act authorizes the state public utility commission, acting as arbitrator, to set the rates that the incumbent may charge.[2]

---

[1] An incumbent's obligation to lease network elements to new entrants extends only to those elements designated by the FCC under Section 251(d)(2). That provision states that, "[i]n determining what network elements should be made available for purposes of" Section 251(c)(3), the FCC "shall consider, at a minimum," certain competitive standards. 47 U.S.C. 251(d)(2). With respect to most elements, the statutory standard that the FCC must consider is whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer." 47 U.S.C. 251(d)(2)(B); see also 47 U.S.C. 251(d)(2)(A) (providing that, with respect to "proprietary" elements, the relevant standard is whether "access to such network elements * * * is necessary"). See note 6, *infra*.

[2] A state commission may opt out of that statutory role, in which case the FCC would resolve individual disputes between carriers over the

The state commissions must set rates that are "nondiscriminatory" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." 47 U.S.C. 252(d)(1).[3] The rates "may include a reasonable profit" for the incumbent. 47 U.S.C. 252(d)(1). In setting such rates, the state commissions must follow the FCC's pricing rules that give content to that statutory standard. See *Iowa Utils. Bd. I*, 525 U.S. at 383-385.

The 1996 Act also conferred significant benefits on incumbent LECs. For example, the 1996 Act "relieves the [regional Bell companies] of several of the burdens imposed by the [1982 AT&T consent decree], particularly by prescribing in [47 U.S.C.] § 271 a method whereby [they] can achieve a long-sought-after presence in the long distance market." *BellSouth Corp.* v. *FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (emphasis and citation omitted); see also 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (superseding GTE consent decree). The 1996 Act further entitles incumbent LECs, like other telecommunications carriers, to invoke its local competition provisions to expand their operations into new geographic areas and compete for the customers of other incumbents.

rates to be charged for providing interconnection and access to network elements. See 47 U.S.C. 252(e)(5).

[3] Section 252(d)(1), titled "Interconnection and network element charges," provides in full:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section—
>
> (A) shall be—
>
> (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
>
> (ii) nondiscriminatory, and
>
> (B) may include a reasonable profit.

2. In August 1996, the FCC issued its initial order addressing the most basic issues involving local competition arising under the 1996 Act. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order* (*Local Competition Order*), 11 F.C.C.R. 15,499 (1996). A cornerstone of that order is the FCC's choice of the cost methodology—"total element long-run incremental cost," or TELRIC—that state public utility commissions are to employ in resolving disputes between carriers about the "cost[s]" that Section 252(d)(1) allows the incumbent to recover from the new entrant for providing interconnection and network elements. See *Local Competition Order* (paras. 674-703), J.A. 376-396.

TELRIC embodies a "forward-looking" approach to calculating the cost of providing network elements and interconnection. The essential objective of any forward-looking methodology is to determine what it would cost in today's market to replace the functions of an asset that make it useful. That is the asset's "forward-looking" cost (also known as its "replacement" or "economic" cost), as distinguished from the cost of duplicating the asset in every physical particular. Thus, under a forward-looking methodology, if an incumbent bought an analog switch in 1985 at a fixed cost of $150 per line, and an efficient carrier would address the same business needs today by purchasing a digital switch at a fixed cost of $100 per line (more efficient digital switches have supplanted analog switches in the market), the latter figure is the appropriate basis for determining what a new entrant would pay the incumbent to lease switching capacity. Similarly, if a loop cost $100 to install in 1985 but would cost $150 to install today (because, for example, labor costs have increased), the rate for leasing that loop would be based on the higher current cost figure.

In asking what it would cost to replace the functions that make an asset valuable, a forward-looking cost methodology requires an inquiry into currently available substitutes—including assets that perform the same functions as the asset in the incumbent's network, but that do not resemble the asset in all respects (*e.g.*, because they embody more efficient technology than the original asset). Some incumbents urged the FCC to foreclose any consideration of currently available substitutes in TELRIC. The FCC rejected the incumbents' suggestion as arbitrarily limiting the inquiry into the forward-looking cost of replacing an asset's useful functions in today's market. See *Local Competition Order* (paras. 683-685), J.A. 382-384.[4]

The forward-looking purchase price of an asset is only one variable in the TELRIC compensation calculus. TELRIC also takes into account (1) the duration of an element's useful life, as reflected in an appropriate economic depreciation schedule; (2) the cost of capital (*i.e.*, the required return, or profit, on investment); and (3) various types of expenses, such as maintenance expenses. See *Local Competition Order* (para. 703), J.A. 396. One of TELRIC's principal objectives is to ensure an incumbent's opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives.

Many of the essential details of implementing TELRIC are left to state public utility commissions. For example, the FCC did not set depreciation schedules itself; rather, state

[4] The FCC determined that TELRIC should, however, take as given the incumbent's existing wire centers (*i.e.*, its switch locations), thereby confining the inquiry to efficient alternatives that are compatible with the basic geographical design of the existing network. *Local Competition Order* (para. 685), J.A. 383-384. The FCC observed that such a limitation would give new entrants additional incentives to save costs by constructing facilities of their own embodying "more efficient network configurations." *Ibid.*

commissions determine, among other things, how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." *Local Competition Order* (para. 686), J.A. 384-385. Similarly, the state commissions have wide discretion to determine the appropriate cost of capital (or return on investment); they are authorized to increase the cost of capital, if warranted, to compensate incumbents for the risk of increased competition. *Local Competition Order* (para. 702), J.A. 395-396.

The FCC rejected the argument of several incumbent LECs that the 1996 Act entitles them to rates for interconnection and network elements that are based on the "historical" (or "embedded") costs reflected on their accounting books. The FCC recognized that those costs could be either higher or lower than forward-looking costs. *Local Competition Order* (para. 705), J.A. 398-399. The FCC reasoned that the use of historical costs would be economically arbitrary and would frustrate the competitive objectives of the 1996 Act. See *Local Competition Order* (paras. 704-711), J.A. 397-403.[5]

3. In 1996 and 1997, the Eighth Circuit stayed and then invalidated the FCC's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the FCC, general jurisdiction to interpret the pricing provisions of Sections 251 and 252. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753,

[5] At the same time that the FCC promulgated the pricing rules discussed in the text, the FCC also promulgated other rules, which have come to be known as the "combinations" rules. See *Local Competition Order* (paras. 292-297), J.A. 295-299. In *Iowa Utilities Board I*, this Court reversed the Eighth Circuit's decision invalidating one of those rules, 47 C.F.R. 51.315(b); on remand, the Eighth Circuit again invalidated others of those rules, 47 C.F.R. 51.315(c)-(f), and this Court granted certiorari to consider that aspect of the court of appeals' decision. We address the combinations rule question in our brief as petitioners in this consolidated case.

794-800 (1997). The Eighth Circuit's jurisdictional orders remained in effect until early 1999. During that period, the great majority of state commissions voluntarily applied the FCC's basic forward-looking methodology in adjudicating disputes between incumbents and new entrants over the rates to be charged for interconnection and network elements. See note 12, *infra*. In January 1999, this Court reversed the Eighth Circuit's jurisdictional ruling, holding that the FCC has statutory authority to establish national pricing standards under Sections 251 and 252. *Iowa Utils. Bd. I*, 525 U.S. at 376-385. The Court remanded the case to the Eighth Circuit to address (among other things) the substantive validity of the FCC's cost methodology.[6]

4. In July 2000, the Eighth Circuit issued its decision on remand. The court upheld the FCC's authority to prescribe a pricing methodology based on forward-looking costs, invalidated a key component of the particular methodology that the FCC adopted, and rejected, as premature, the incumbents' Takings Clause challenge to the methodology. U.S. Pet. App. 10a-18a.

First, the court of appeals rejected the incumbents' argument that, in providing that the rates that they may charge new entrants for interconnection and network elements are to be based on "cost," Congress dictated a methodology based on historical cost. The court concluded that "the term 'cost,' as it is used in the statute, is ambiguous, and

[6] This Court separately upheld several of the FCC's rules on the merits but invalidated a portion of the FCC's original implementation of the "necessary" and "impair" standards of Section 251(d)(2), see note 1, *supra*, and remanded to the FCC for further rulemaking. See *Iowa Utils. Bd. I*, 525 U.S. at 387-392. The FCC issued an order on remand in December 1999. See *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking*, 15 F.C.C.R. 3696 (1999), petitions for review pending *sub nom. United States Telecomm. Ass'n* v. *FCC*, Nos. 00-1015 et al. (D.C. Cir. Jan. 19, 2000).

Congress has not spoken directly on the meaning of the word in this context." U.S. Pet. App. 11a. The court therefore recognized that the FCC has the authority to make reasonable rules to resolve any such ambiguity. *Id.* at 11a-12a (citing *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984)). The court then concluded that the FCC's adoption of a methodology based on forward-looking costs was reasonable. *Id.* at 12a. The court noted that "[f]orward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the [1996] Act." *Ibid.* The court found that the FCC had adequately explained its conclusion that a methodology based on forward-looking costs "would best ensure efficient investment decisions and competitive entry," and thus "implement the new competitive goals of the Act." *Ibid.*

Second, the court of appeals invalidated the FCC's rule specifying that, apart from the "wire center" exception (see note 4, *supra*), the forward-looking cost of an element should be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration," 47 C.F.R. 51.505(b)(1). U.S. Pet. App. 6a-10a. The court held that the regulation is contrary to "the plain meaning" of Section 252(d)(1) and thus does not satisfy step one of this Court's *Chevron* analysis. *Id.* at 8a; see also *id.* at 4a.[7]

Third, the court of appeals rejected, as premature, the incumbents' assertion that the FCC's methodology, including its consideration of forward-looking costs, raises a serious Fifth Amendment takings issue that the 1996 Act should be construed to avoid. The court concluded that "the present takings claim is not ripe for review" because, "[u]ntil the actual rates are established" by state public utility commissions, "we cannot conclude whether the impact of

[7] That aspect of the court of appeals' opinion is among the questions presented by our petition in this consolidated case.

TELRIC driven rates will constitute a taking." Pet. App. 17a. The court observed that a mere "possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction." *Id.* at 17a-18a (citing *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-129 (1985)).

5. The local competition provisions of the 1996 Act are complemented by 47 U.S.C. 254, the provision of the 1996 Act relating to "universal service." For many years, federal and state regulators sought to ensure low rates for subscribers in "high cost" areas through a variety of implicit and explicit cross-subsidy mechanisms. For example, incumbent LECs often charged retail rates to customers in densely populated urban areas that well exceeded the cost of serving those customers; those revenues were then used to subsidize the retail rates charged customers in remote rural areas that are much more expensive to serve. Congress recognized that the emergence of local competition would tend to erode the source of such cross-subsidies, as new entrants won the business of customers who would otherwise pay above-cost rates to incumbents. A central objective of Section 254 is to phase out the implicit cross-subsidies and replace them with explicit and competitively neutral funding mechanisms supported by all providers of telecommunications services, including new entrants that provide service through the use of an incumbent's network elements under Section 251(c)(3).

In 1997, the FCC issued rules implementing Section 254 and, among its determinations, chose a forward-looking cost methodology similar to TELRIC as a key factor in determining the level of federal funding to supplement state efforts to subsidize affordable service to high cost areas. See *In re Federal-State Joint Bd. on Universal Serv., Report and Order*, 12 F.C.C.R. 8776 (1997). In 1999, the Fifth Circuit adjudicated various challenges to that Order. *Texas Office of Pub. Util. Counsel* v. *FCC*, 183 F.3d 393 (1999).

Among its holdings, that court rejected the argument of certain incumbent LECs that construing Section 254 to permit the use of a methodology based on forward-looking costs is barred by the Takings Clause. *Id.* at 413 & n.14. In June 2000, this Court granted a petition for a writ of certiorari on that issue, filed by GTE, one of the corporate predecessors (along with Bell Atlantic) to Verizon Communications, Inc. *GTE Serv. Corp.* v. *FCC*, 530 U.S. 1213 (No. 99-1244). On November 2, 2000, the Court granted Verizon's unopposed motion to dismiss that case. 121 S. Ct. 423.

SUMMARY OF ARGUMENT

In order to stimulate competition in local telecommunications markets, Congress, in the 1996 Act, gave new entrants the right to interconnect with, and to lease elements of, incumbents' existing networks. 47 U.S.C. 252(c)(2) and (3). Congress provided that incumbents would be compensated for doing so at rates based on "the cost * * * of providing the interconnection or network element." 47 U.S.C. 252(d)(1)(A). The FCC, in the rulemaking prescribed by the 1996 Act, determined that such rates should be based on forward-looking costs—*i.e.*, the cost of obtaining the features or functions of a network element that make it useful—rather than the historical costs reflected on incumbents' accounting books. The FCC reasoned that setting network element rates on the basis of forward-looking costs, which emulate rational economic choices in a competitive market, would send appropriate signals for entry, investment, and pricing in markets moving from monopoly to competition. The FCC's choice of a methodology based on forward-looking costs is reasonable and is consistent with the text, structure, and purposes of the 1996 Act.

A. In so holding, the court of appeals recognized that "the term 'cost,' as it is used in the [1996 Act], is ambiguous, and Congress has not spoken directly on the meaning of the word in this context," U.S. Pet. App. 11a. Accordingly, the FCC is

authorized to adopt reasonable rules to resolve that ambiguity. See *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984).

1. Verizon nonetheless contends, relying on dictionary definitions, regulatory practice, and other provisions of the 1996 Act, that the word "cost" in 47 U.S.C. 252(d)(1) can refer *only* to historical cost. Verizon is mistaken.

First, the dictionary definitions on which Verizon relies, which equate "cost" with the amount paid or to be paid for an item, do not contain any temporal restriction. Those definitions could equally refer to the amount that would be paid for the item today (*i.e.*, the forward-looking cost), as opposed to the amount that was paid for the item in the past (*i.e.*, the historical cost).

Second, at different times and in different contexts, regulators have used both forward-looking and historical costs to set rates, and this Court has recognized that neither approach is compelled either by the Constitution or by various statutes authorizing ratemaking in similarly general terms. Indeed, in the particular context of opening local telecommunications markets to competition, state regulators had already concluded, in advance of the enactment of the 1996 Act, that forward-looking costs should be used to set the rates at which incumbents provide facilities to new entrants. It is unlikely that Congress intended to foreclose such an approach in the new competitive environment contemplated by the 1996 Act.

Third, the other provisions of the 1996 Act on which Verizon relies do not dictate any particular construction of the word "cost" in Section 252(d)(1). Rather, those provisions provide further indication of the considerable discretion that Congress vested in the FCC to implement the Act. For example, the statutory provision that network element rates "*may* include a reasonable profit," 47 U.S.C. 252(d)(1)(B) (emphasis added), not only does not limit the FCC to adopting a particular definition of "cost," since the concept of

profit is equally relevant to forward-looking and historical approaches; the provision also reflects that Congress intended that the FCC would make fundamental choices about the rate methodology, including choices concerning whether, or how, profit is to be taken into account.

2. Nor does the doctrine of constitutional avoidance require a construction of Section 252(d)(1) that reads the term "cost" to refer exclusively to historical cost. Verizon has not demonstrated that the FCC's forward-looking cost methodology presents serious Takings Clause concerns. And that is true whether one considers the impact of the methodology on incumbents' overall returns, as this Court's precedents indicate, or on incumbents' compensation for network elements standing alone.

In a series of cases, including *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 312, 314 (1989), the Court has explained that a change in regulatory methodology—including one that denies a regulated company recovery of prudently incurred historical costs—constitutes a taking only if "the net effect" of the change is to "leav[e] [the company] insufficient operating capital" or "imped[e] [its] ability to raise future capital." No such "net effect" has been shown here. To the contrary, the incumbents have continued to enjoy generous returns, on both their interstate and intrastate activities, in the years since they were required to lease network elements at rates based on forward-looking costs.

In any event, even if one focuses on the adequacy of the incumbents' compensation for leasing network elements in isolation, Verizon has offered no cogent reason to conclude that the incumbents will receive constitutionally inadequate compensation under a methodology based on forward-looking costs. Under traditional just compensation principles, when the government commits private property to public use, it is required to pay the owner the fair market value of the property. The government is not required to pay the owner whatever higher price the property might have

fetched in the past. The concept of fair market value is closely akin to the concept of forward-looking cost; both focus on the cost of an item in the current market, which may reflect changes in technology, production, or other factors since the item was originally placed into service.

Verizon also asserts that the FCC's methodology will leave the incumbents with "stranded investment" for which they will never be fully compensated. But *Duquesne* recognizes that the Constitution does not prohibit all regulatory changes that produce stranded investment, but only those that have a confiscatory effect on a company's net returns. The FCC found in this proceeding, moreover, that the incumbents' claims of stranded investment were unsubstantiated and were based on unrealistic assumptions about the rate of competitive entry into local markets. The passage of time has given no greater validity to the incumbents' claims. In any event, the FCC has expressly preserved the option of providing a remedy for stranded investment, if the incumbents demonstrate the need for one.

B. The FCC's decision to adopt a forward-looking methodology for setting network element rates satisfies the reasoned decisionmaking standards of the Administrative Procedure Act, 5 U.S.C. 701 *et seq.* The FCC reasonably concluded, and adequately explained, that a forward-looking methodology would most effectively implement Congress's purposes underlying the 1996 Act—*i.e.*, to expedite the development of competition in local telecommunications markets, to facilitate the efficient use of existing network facilities, and to encourage new entrants to make economically rational choices about whether, or how, to enter local markets. At the same time, the FCC recognized that the use of a historical cost methodology could impair the development of competition; in those circumstances where historical costs exceed forward-looking costs, for example, competitors could be deterred from entering the market or induced to construct inefficient, duplicative facilities.

Contrary to Verizon's assertions, the FCC's choice of a forward-looking methodology does not undermine Congress's goal of encouraging efficient facilities-based competition. It was, after all, Congress, not the FCC, that made the decision to accelerate competition in local telecommunications markets by enabling new entrants to lease some elements of incumbents' networks, as many new entrants must in order to develop competitive services. As the FCC recognized, a historical-cost approach would arbitrarily impede new entrants' ability to use that entry vehicle. Moreover, as experience since the adoption of the 1996 Act indicates, new entrants are offering competing local telecommunications services through facilities that they have purchased or built, as well as through facilities leased from incumbents and through resale. Indeed, new entrants have strong practical incentives to avoid having to rely on incumbents to provide the facilities on which they depend to serve their customers.

Finally, there is no merit to Verizon's suggestion that a forward-looking approach is so "administratively unworkable" that the FCC lacked discretion to adopt it. As explained above, the FCC concluded that a forward-looking approach is far superior to a historical approach for measuring the costs relevant here—the costs on which incumbents would base charges for network elements in a truly competitive market. Moreover, as demonstrated by decades of experience, a historical cost approach, no less than a forward-looking one, presents significant administrative difficulties. Under a historical approach, no less than under other approaches, regulators would have to make complex judgment calls about appropriate depreciation rates, rates of return, and allocations of joint and common costs to various aspects of the network.

ARGUMENT

I. THE FCC REASONABLY CONSTRUED SECTION 252(D)(1) OF THE 1996 ACT TO PERMIT THE USE OF FORWARD-LOOKING COSTS TO DETERMINE NETWORK ELEMENT PRICES

A. The FCC's Construction Of "Cost" Is Consistent With The Language, Structure, And Purposes Of The Act

1. In the 1996 Act, Congress provided that the "just and reasonable rate" at which an incumbent LEC may lease a network element to a new entrant is a rate "based on the cost * * * of providing the * * * network element." 47 U.S.C. 252(d)(1)(A). As the court of appeals recognized, Congress did not itself prescribe how that "cost" is to be determined; rather, Congress left it to the FCC to determine which of the various possible methods for measuring "cost" would best serve the purposes of the Act. See U.S. Pet. App. 11a ("We conclude the term 'cost,' as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context."); see generally *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 397 (1999) (observing that the 1996 Act "is in many important respects a model of ambiguity"—ambiguity that "Congress [was] well aware" would "be resolved by the implementing agency").

In making that determination, the FCC considered the comments of economists and other experts as well as the experience of those States that had already moved to open their own local telecommunications markets to competition. The FCC concluded that the appropriate "cost * * * of providing" a network element, for purposes of Section 252(d)(1), is the forward-looking cost of that element—*i.e.*, the cost in today's market of obtaining the features or functions of the element that make it useful. The FCC noted that the forward-looking cost of an element may, depending upon the

individual context, be either higher or lower than its historical cost. See *Local Competition Order* (para. 705), J.A. 398-399.[8]

The FCC found support for its adoption of a forward-looking cost methodology in the purposes of the 1996 Act: to stimulate the expeditious development of competition in local telecommunications markets; to ensure the efficient use of existing network facilities, many of which embody significant economies of scale and scope; and to encourage new entrants to make economically rational decisions about whether, or how, to enter a given market. The FCC explained that setting prices under a forward-looking methodology emulates rational economic behavior in a competitive market, because a firm considers forward-looking costs, not historical costs, in making decisions about entry, expansion, and price. See *Local Competition Order* (paras. 620, 679, 740), J.A. 327-328, 379-380, 422-423; see also *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989) (forward-looking costs "mimic[] the operation of the competitive market"); *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-1117 (7th Cir.) ("[I]t is current and anticipated cost, rather than historical cost that is relevant to business decisions to enter markets."), cert. denied, 464 U.S. 891 (1983). The FCC thus concluded that the forward-looking methodology embodied in TELRIC would send appropriate signals for entry, investment, and pricing to potential competitors in local telecommunications

---

[8] Thus, although "[t]he FCC fully understood that TELRIC rates would be below historical costs" (Verizon Pet. Br. 28) in many instances, the FCC also understood that TELRIC rates could be above historical costs depending upon individual circumstances. Indeed, when the Iowa Utilities Board challenged the FCC's jurisdiction to set prices for network elements, it expressed concern that TELRIC would produce higher, not lower, network element rates in Iowa than would a historical cost methodology. See Mot. of Iowa Utils. Bd. for Stay at 9, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir. Sept. 19, 1996).

markets. See *Local Competition Order* (paras. 620, 630), J.A. 327-328, 333-334.

2. Verizon nonetheless contends (Verizon Pet. Br. 19-23) that the term "cost," as used in Section 252(d)(1), must be construed, under step one of *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984), to refer exclusively to historical costs. Verizon asserts that its preferred reading is compelled by dictionary definitions, traditional regulatory usage, and statutory structure. The court of appeals correctly rejected that claim. See U.S. Pet. App. 10a-14a.

a. Verizon first attempts to read a historical component into dictionary definitions describing "cost" as, for example, "the amount or equivalent paid or given or charged or engaged to be paid or given for anything." Verizon Pet. Br. 19. But such conventional definitions accommodate forward-looking and historical interpretations with equal ease. Those definitions do not specify whether the relevant "cost" is an amount that would be paid or charged today to provide network elements (*i.e.*, the forward-looking cost) or an amount that was paid or charged in the past (*i.e.*, the historical cost).

Courts and commentators have recognized that the word "cost" is "one of equivocal meaning," *Strickland* v. *Commissioner, Me. Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir.) (quoting 20 C.J.S. *Cost* (1940)), cert. denied, 516 U.S. 850 (1995), which may encompass both forward-looking and historical costs. See, *e.g.*, *MCI Communications*, 708 F.2d at 1116-1117 (observing that methodologies based on forward-looking cost (*e.g.*, "long-run incremental cost") and historical cost (*e.g.*, "fully distributed cost") "can be viewed as simply different ways of defining the average total cost ('ATC') of a particular product or service") (emphasis omitted). As Justice Breyer noted in his separate opinion in *Iowa Utilities Board I*, "general terms" of the sort used in the 1996 Act to articulate the network element pricing standard—such as the term "based on * * * cost" in Section 252(d)(1)—"give ratesetting commissions broad methodological leeway" and

"say little about the 'method employed' to determine a particular rate." 525 U.S. at 423 (Breyer, J., concurring in part and dissenting in part).[9]

It was particularly reasonable for the FCC to construe the 1996 Act to authorize a forward-looking cost methodology, because, under the plain language of Section 252(d)(1), rates are to be based "on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." The "cost * * * of providing" a network element—such as a local loop connecting a house to a telephone switch—is most reasonably construed as the cost of procuring that element on today's market. It cannot as readily be construed as the cost that an incumbent happened to pay for its facilities many years in the past.

b. Contrary to Verizon's assertion, regulatory history supplies no single definitive meaning of "cost." Indeed, one of the treatises upon which Verizon relies for a fixed reading of "cost" to mean historical cost acknowledges that, in the utility ratemaking context in particular, "'[c]ost' * * * is a word of many meanings"—including, specifically, both historical "original-cost" and forward-looking "reproduction-cost." James C. Bonbright et al., *Principles of Public Utility Rates* 109 (2d ed. 1988). Thus, although the term "cost" today is not confined to forward-looking cost,[10] the "view of

---

[9] Accord, *e.g.*, *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983) (observing that the statutory term "attributable costs," which Congress directed the Postal Service to consider in setting postal rates, "has no technical meaning" and "connotes the use of judgment" by the expert agency); *Alabama Elec. Coop., Inc.* v. *FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982) (noting that "[c]ost itself is an inexact standard").

[10] Ratemaking based upon "fair value," a version of forward-looking cost, was once thought to be constitutionally required. See *Smyth* v. *Ames*, 169 U.S. 466 (1898); see also Richard J. Pierce, Jr., *Public Utility*

historic cost as the apodictically indicated measure of 'actual cost,' is not * * * supported by the applicable law." *City of Los Angeles Dep't of Airports* v. *United States Dep't of Transp.*, 103 F.3d 1027, 1032 (D.C. Cir. 1997).

Moreover, as we previously noted (see U.S. Pet. Br. 24-25), regulators, with court approval, have long employed methodologies based on forward-looking costs. In the 1980s, for example, the Interstate Commerce Commission (ICC) adopted a forward-looking cost methodology, based on "most efficient" alternatives, to determine the maximum rate that a market-dominant railroad could charge a coal shipper that was the "captive" of that railroad.[11] See also, *e.g.*, *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 219, 221-226 (1991) (upholding FERC's "replacement-cost-based method" of pricing existing natural

Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?, 77 Geo. L.J. 2031 & n.5 (1989) (cataloguing cases).

[11] Under the ICC's standard, the railroad could charge the captive shipper no more than the "stand alone" cost of transporting the coal, defined as the forward-looking cost that the shipper itself would incur were it to transport the coal to its destination using the most efficient railroad system that could be configured to accomplish that task. See Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-546 (1985), aff'd *sub nom. Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444, 1451, 1457 (3d Cir. 1987); see also Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide* (unpublished decision issued Feb. 8, 1983), slip op. 10-13 (delineating substantially similar interim standard). The D.C. Circuit (in an opinion joined by then-Judge Scalia) upheld the ICC's use of that methodology. The court reasoned that, although the methodology "deals with hypothetical and not actual transportation situations, it provides an appropriate analytical tool for determining whether a return on noncompetitive traffic 'properly reflects the high demand for the service, but is not set at an unreasonably high or "monopoly" level.'" *Potomac Elec. Power Co.* v. *ICC*, 744 F.2d 185, 193-194 (D.C. Cir. 1984) (quoting interim ICC Guidelines); see also *Consolidated Rail Corp.*, 812 F.2d at 1453-1457 (affirming in full final ICC guidelines); *Burlington N. R.R.* v. *Surface Transp. Bd.*, 114 F.3d 206, 212-215 (D.C. Cir. 1997) (affirming application of those guidelines).

gas, which "approximated * * * the current cost of finding new gas fields, drilling new wells, and producing new gas").

In the years preceding the enactment of the 1996 Act, a number of state public utility commissions, in acting to open their own local telecommunications markets to competition, recognized the appropriateness of using forward-looking costs as the basis for determining the rates at which incumbents could be required to open their facilities to new entrants. See *Local Competition Order* (paras. 631, 681), J.A. 334-336, 381.[12] The European Commission has endorsed a forward-looking methodology similar to TELRIC—based on a model hypothesizing "an efficient operator employing modern technology"—as a means of opening European telecommunications markets to competition.[13] It is exceedingly

[12] Moreover, during the period from 1996 through early 1999 when the FCC's pricing rules were stayed and then vacated by the Eighth Circuit on jurisdictional grounds, the overwhelming majority of state commissions independently and voluntarily embraced the essentials of TELRIC in their implementation of the local competition provisions of the 1996 Act. See Peter W. Huber, Michael K. Kellogg & John Thorne, *Federal Telecommunications Law* § 2.4.4.1, at 185 (2d ed. 1999) ("While the *Iowa Utilities Board* case was being litigated, most states used their price-setting authority in ways closely following the FCC models."). The federal courts have consistently endorsed that choice on the merits in their review of the state commissions' actions. See, *e.g.*, *GTE S. Inc.* v. *Morrison*, 6 F. Supp. 2d 517, 528-530 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-744, 749 (4th Cir. 1999); *Bell Atl.-Del., Inc.* v. *McMahon*, 80 F. Supp. 2d 218, 235-236 (D. Del. 2000).

[13] See *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market (Pt. 1, Interconnection Pricing)*, O.J. 1998 L073/42 ("Interconnection costs should be calculated on the basis of forward-looking long run average incremental costs, since these costs closely approximate those of an efficient operator employing modern technology."); see also Hank Intven, Jeremy Oliver & Edgardo Sepulveda, *Telecommunications Regulation Handboook* 3-25 (World Bank 2000) ("[T]oday most regulators and experts generally agree that the ideal approach for calculating the level of interconnection charges would be one based on forward-looking costs of supplying the relevant facilities and

unlikely that Congress intended to foreclose the FCC from adopting the very methodology that other regulators had found singularly appropriate to promote competition in the telecommunications industry and other regulated industries.

c. The structure of the 1996 Act's local competition provisions does not, as Verizon suggests, demand that "cost" in Section 252(d)(1) be read to mean "historical cost." Indeed, the very provisions on which Verizon relies suggest, if anything, that Congress intended to vest the FCC with broad discretion in selecting an appropriate cost methodology.

First, Verizon claims that reading "cost" as "historical cost" is necessary to give meaning to Section 252(d)(1)(B), which states that rates for interconnection and network elements "may include a reasonable profit." Verizon Pet. Br. 20. That is so, Verizon asserts, because "profit" generally means an excess in returns over costs, while the Order at issue here viewed profit as one component of forward-looking costs themselves, leaving no independent significance to the separate statutory reference to "profit." *Id.* at 21.

As the court of appeals recognized, however, "[a] 'profit' can be made whether a historical cost or forward-looking cost methodology is used." U.S. Pet. App. 13a. Verizon's arguments turn not on a difference between historical costs and forward-looking costs, but on a difference between two permissible characterizations of "profit," each of which is equally applicable to a historical cost regime or a forward-looking cost regime. Under either regime, "profits" may be characterized as either (1) the recovery of revenues in excess of (historical or forward-looking) costs, with costs defined to exclude the opportunity costs represented by the decision to invest capital in telecommunications plant rather than elsewhere or (2) the recovery of a particular (historical or

---

services."); *id.* at 3-23 (noting countries that have adopted such an approach).

forward-looking) cost itself, *i.e.*, the opportunity cost of capital. See *Local Competition Order* (paras. 699-703), J.A. 393-396. The FCC's description of a "reasonable profit" as the recovery of the cost of capital (along with all other relevant costs) under a forward-looking regime reflects the latter characterization. But that does not mean that the FCC was reading the reference to "profit" out of Section 252(d)(1).

Moreover, as the court of appeals observed, Congress's "use of the word 'may' [in Section 252(d)(1)(B)] indicates that the inclusion of a reasonable profit is not mandatory but permitted." U.S. Pet. App. 13a. Such discretionary language provides additional support for the conclusion that Congress was not itself dictating any particular pricing methodology for network elements. Rather, Congress sought to leave to the FCC the task of formulating the details of the pricing methodology, specifically including the question of whether, or how, profit is to be taken into account.

Second, Verizon contends that the accelerated implementation schedule that Congress established with respect to the local competition provisions of the 1996 Act, see 47 U.S.C. 251(d)(1), and the prohibition on the use of rate-of-return or other rate-based proceedings in establishing rates, see 47 U.S.C. 252(d)(1), create the "strong inference * * * that 'cost' refers to something already established and readily available, *i.e.*, historical cost as documented on incumbents' books." Verizon Pet. Br. 22. Both provisions, to the extent that they bear on the matter at all, militate against Verizon's construction of "cost."

Section 251(d)(1)'s directive that the FCC complete within six months "all actions necessary to establish regulations to implement the requirements of this section" reflects Congress's intent to expedite competitive entry into local markets. See *Local Competition Order* (para. 704), J.A. 397-398. The FCC's construction of "cost" advances that objective better than does Verizon's construction. As the FCC concluded, setting rates for network elements on the

basis of forward-looking costs will stimulate the development of efficient competition, while setting rates on the basis of historical costs would retard and distort such competition. See *Local Competition Order* (paras. 620, 705), J.A. 327-328, 398-399.

The parenthetical restriction in Section 252(d)(1)(A)(i), which requires network element rates to be "determined without reference to a rate-of-return or other rate-based proceeding," "does not further define the type of costs that may be considered." *Local Competition Order* (para. 704), J.A. 397-398. But that provision does contemplate some departure from traditional forms of ratemaking for telephone companies, which had been conducted pursuant to historic cost-based "rate-of-return or other rate-based proceedings." In any event, Verizon's reliance on that parenthetical restriction starts from the false premise that the historical costs of network elements (*e.g.*, network "features, functions, and capabilities," 47 U.S.C. 153(29)) were "already established and readily available" on incumbents' accounting books, and thus could be applied in streamlined ratemaking proceedings. See Verizon Pet. Br. 22. In fact, historical cost data in the telecommunications industry traditionally focused on an incumbent's revenue needs in other contexts, not on the proper level of compensation for the competitive use of discrete facilities. The use of such existing data to develop reliable historical cost figures for particular categories of facilities would, therefore, have been exceedingly difficult. See pp. 48-49, *infra*.

Third, Verizon argues that, because the 1996 Act ties the wholesale rates that new entrants may be charged for telecommunications services sold for resale under Sections 251(c)(4) and 252(d)(3) to incumbents' retail rates (which allegedly were set on the basis of historical costs), principles of symmetry in statutory construction dictate that historical costs be the basis for network element rates as well. Verizon Pet. Br. 22-23. But nothing in the text of Sections

251(c)(4) and 252(d)(3) — which provide that new entrants may purchase such services "at wholesale rates," which are to be based on "retail rates charged to subscribers"—inexorably ties those rates to historical costs.[14] Any such connection depends upon the particular ratemaking method that state regulators employed to develop the pertinent retail rates.

Moreover, even if the rates for services sold for resale would in many instances be derived in some respect from historical costs, that does not mean that Congress intended that network element rates also would be tied to historical costs. The network element and resale entry vehicles are separate options for new entrants and serve distinct purposes. The pricing standards for those entry vehicles are contained in separate statutory subsections and are described in distinct terms. Section 252(d)(1) provides that rates for network elements should be based upon "cost" and thus should be developed from the ground up. Construing "cost" to mean forward-looking cost serves the competitive purposes of the 1996 Act by ensuring that new entrants make efficient choices about whether to lease network elements or build facilities of their own. *Local Competition Order* (para. 620), J.A. 327-328.

Section 252(d)(3), on the other hand, provides that wholesale rates for resale services should be developed from the top down—starting with existing retail rates and excluding the portion of such rates attributable to categories of "costs that will be avoided by the local exchange carrier."

---

[14] Section 252(d)(3) provides that:

> For the purposes of section 251(c)(4) of this title, a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

47 U.S.C. 252(d)(3).

That standard recognizes that incumbents' retail rate structures traditionally have been laden with implicit subsidies and thus are not necessarily cost-based (with reference to either historical or forward-looking costs). The wholesale rate standard ensures that companies choosing to enter the market through resale have a margin within which to compete, regardless of whether an incumbent's retail service rates are cost-based, above-cost, or below-cost.[15] Given the different purposes underlying the pricing standards for network elements and resale services, as well as the different statutory language describing those standards, there is no reason to conclude that Congress intended that the pricing standards be symmetrical in their reliance on historical costs. In other words, even if Congress understood that wholesale rates for retail services ordinarily (but not invariably) would have historical cost-based retail rates as a starting point, it would not follow that Congress intended that rates for network elements be based on historical, not forward-looking, costs.

B. The Principle Of Constitutional Avoidance Does Not Require That "Cost" Be Construed As Historical Cost

Verizon next invokes the principle of constitutional avoidance to advance its construction of the term "cost" in Section 252(d)(1). Verizon contends that, in order to avoid Takings Clause concerns, Section 252(d)(1) must be construed to

[15] Congress's purpose of ensuring a margin for competitive entry through resale even for non-cost-based rates is evident in Section 251(c)(4)(B), which permits state commissions to "prohibit a reseller that obtains at wholesale rates a telecommunications service that *is* available at retail only to a category of subscribers from offering such service to a different category of subscribers." Presumably, Congress intended that the provision could apply, for instance, to services provided at below-cost retail rates (*e.g.*, for rural customers), so that new entrants could compete with incumbents with respect to subsidized services, but could not extend the subsidy to new classes of customers that were not beneficiaries of the subsidy under state ratemaking policy.

allow incumbent LECs to lease network elements at rates based on whatever amount the incumbents may have paid for those elements in the past. Verizon Pet. Br. 24-31.

This Court and others have rejected efforts to invoke the avoidance principle in the Takings Clause context to "frustrate[] permissible applications of a statute or regulation" absent a concrete showing that government action will necessarily produce a taking without just compensation. *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 (1985); *National Mining Ass'n* v. *Babbitt*, 172 F.3d 906, 917 (D.C. Cir. 1999); cf. *Federal Power Comm'n* v. *Hope Natural Gas*, 320 U.S. 591, 602 (1944) (one who challenges the constitutionality of a ratemaking order "carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences").[16] Verizon has not even attempted to make such a showing here.

As an initial matter, any suggestion that the FCC's adoption of TELRIC will deny the incumbent LECS constitutionally adequate compensation has a speculative quality, since the actual rates that incumbents may charge for network elements are ultimately set by state public utility commissions, not by the FCC itself. The FCC has simply

[16] Verizon contends that *Riverside Bayview* has no application where the constitutional concern is not whether a taking has occurred, but rather whether the compensation for the taking is just. Verizon Pet. Br. 43. But *Riverside Bayview* is appropriately viewed as a specific application of the principle that the constitutional avoidance doctrine is properly invoked to prevent "serious constitutional problems," not merely speculative ones. Nor is *United States* v. *Security Industrial Bank*, 459 U.S. 70 (1982), to the contrary. The Court has explained that *Security Industrial Bank* involved a "substantial" claim that a particular construction of a statute "would in every case constitute a taking." *Riverside Bayview*, 474 U.S. at 128 n.5. Verizon does not attempt to demonstrate that the application of TELRIC would produce unconstitutional results in all, or even a substantial number of, applications.

established the methodology that the state commissions are to apply in individual circumstances. The FCC also has not prescribed specific depreciation rates or rates of return—both of which are necessary components of any network element rates established under TELRIC. Instead, the FCC has left it to state commissions to establish rates of return and depreciation rates. See *Local Competition Order* (para. 702), J.A. 395-396; see also U.S. Pet. App. 17a (court of appeals observes that, "[u]ntil the actual rates are established" by state commissions for network elements, "we cannot conclude whether the impact of TELRIC driven rates will constitute a taking"). In addition, the FCC has expressly stated that incumbents may "seek relief from [its] pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Local Competition Order* (para. 739), J.A. 422. The FCC's acknowledgment of the potential for relief where confiscation can be demonstrated—rather than merely asserted—undermines any suggestion that the Order at issue will produce confiscatory results in *any* circumstance. Even aside from the foregoing considerations, Verizon has failed to demonstrate that TELRIC raises serious constitutional concerns.

As regulated public utilities, incumbent LECs are subject to the regulatory takings analysis of *Duquesne Light Co.*, *supra*, and *Hope Natural Gas*, *supra*. In *Duquesne*, as in a consistent line of earlier decisions, this Court rejected the argument that the Takings Clause protects utilities from regulatory measures that deny them recovery of all prudently incurred historical costs. See 488 U.S. at 301-302, 307-316; accord *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517-520 (1979); *Market St. Ry.* v. *Railroad Comm'n*, 324 U.S. 548, 553-554, 564-568 (1945). The Court explained that the Constitution protects a public utility only from "the net effect of the rate order on its property," *Duquesne*, 488 U.S. at 314, so that "[i]f the total effect of the rate order cannot be

said to be unreasonable, judicial inquiry . . . is at an end," *id.* at 310 (quoting *Hope*, 320 U.S. at 602).

Here, as in *Duquesne*, whether or not the challenged methodology denies regulated companies full recovery of certain prudently incurred historical costs is itself of no constitutional significance. Indeed, unlike in *Duquesne*, the incumbents here are allowed to recover the full forward-looking costs of the facilities at issue—a measure closely analogous to fair market value, which is the standard for determining whether the government has paid just compensation for private property taken for public use. See pp. 35-36, *infra*. And here, as in *Duquesne*, "[n]o argument has been made" that the regulatory measure at issue "jeopardize[s] the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." 488 U.S. at 312. To the contrary, Verizon and most other incumbents have enjoyed extremely healthy returns in recent years, *after* they were required to lease network elements at rates based on forward-looking costs.[17]

1. Verizon nonetheless contends that the FCC's adoption of TELRIC is inconsistent with *Duquesne* on the theory that

---

[17] The interstate rates of return on the major incumbents' regulated activities in 1999, as measured under a historical cost approach, showed a weighted arithmetic mean of 18.50%, including returns of 22.89% for GTE, 20.99% for BellSouth, 18.80% for SBC Communications, 19.06% for U S WEST, and 13.66% for Bell Atlantic. See Interstate Rate of Return Summary (FCC Apr. 10, 2001) (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf). Preliminary reports on interstate regulated earnings in 2000 show even higher average returns of 19.53%. See Interstate Rate of Return Summary, Years 1991 through 2000 (FCC May 3, 2001) (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf); see also Seth Schiesel, *No End to Upheaval in Telecom Industry*, N.Y. Times, Dec. 18, 2000, at C30 ("The local phone giants that formerly had Bell in their names, led by Verizon Communications and SBC Communications, are ascendant these days, even as the long-distance industry essentially collapses around them.").

the FCC has improperly "switche[d]" compensation methodologies. Verizon Pet. Br. 26-31.[18] That argument turns *Duquesne* on its head. In *Duquesne*, the Court upheld a state law that "suddenly and selectively," 488 U.S. at 313, foreclosed recovery of a $35 million investment that was prudent when made, even though the methodology in effect at the time of the investment would have permitted such recovery. Thus, *Duquesne* affirms the discretion of regulators to alter rate-setting methodologies to accommodate changes in regulatory policy, even if, as in *Duquesne* itself, the new methodology results in "stranded" investment.

Verizon counters that a change in methodologies is permissible under *Duquesne* only if the new methodology produces a constitutionally adequate rate of return as measured under the old methodology. Verizon Pet. Br. 27-28. That argument is both inaccurate and irrelevant.

In the first place, *Duquesne* holds no such thing. The passage on which Verizon relies states a sufficient, but not necessary, basis for rejecting the utility's constitutional claim in that case. See *Duquesne*, 488 U.S. at 312. And, even if *Duquesne* did stand for the rule that Verizon ascribes to it, such a rule would not advance Verizon's position here. Under any plausible reading of *Duquesne*, the relevant question is the "overall impact," *ibid.*, of a methodological decision on a utility's regulated returns, not the amount of

[18] It is well settled that, within reasonable bounds, companies operating in regulated industries have no vested interest in any particular regulatory regime. See, *e.g.*, *General Tel. Co. of the S.W.* v. *United States*, 449 F.2d 846, 864 (5th Cir. 1971) ("The property of regulated industries is held subject to such limitations as may reasonably be imposed upon it in the public interest and the courts have frequently recognized that new rules may abolish or modify pre-existing interests."); cf. *Lucas* v. *South Carolina Coastal Council*, 505 U.S. 1003, 1027 (1992) ("the property owner necessarily expects the uses of his property to be restricted, from time to time, by various measures newly enacted by the State in legitimate exercise of its police powers").

cost recovery allowed for individual facilities, such as a nuclear power plant in *Duquesne* or a telephone loop here. Verizon has made no effort to show that the "overall impact" of the FCC's adoption of a forward-looking methodology to determine the rates at which network elements are leased leaves incumbents with a constitutionally inadequate return, even as measured under a historical cost methodology. See note 17, *supra*.

Moreover, Verizon's argument rests on the erroneous premise that, until 1996, the FCC had committed itself to a historical cost methodology and that its adoption of TELRIC marked an abrupt departure from that commitment. See Verizon Pet. Br. 29. It is true that state and federal regulators for many years used historical costs as the basis for setting retail rates paid by consumers and charges for particular services (such as use of the local network to originate or terminate long-distance calls). The Order under review here does not regulate those rates and charges.[19] It instead regulates the charges paid by new entrants for the use of network elements—an activity that had little precedent from which the FCC can be accused of departing. And, even in those other contexts, the FCC and many state commissions abandoned a pure historical cost approach years ago because of its methodological shortcomings. See, *e.g.*, *National Rural Telecom Ass'n* v. *FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993) (discussing price cap regime). Thus, in adopting a forward-looking methodology in the present context, the FCC not only was addressing a new regulatory subject matter, but also was continuing a trend away from traditional forms of regulation based on historical costs.

[19] See generally *Access Charge Reform, Sixth Report and Order*, FCC No. 00-193 (May 31, 2000), petitions for review pending *sub nom. Texas Office of Pub. Util. Counsel* v. *FCC*, No. 00-60434 (5th Cir. filed June 26, 2000) (and consolidated cases).

Even if there were some plausible basis (which there is not) for contending that the government has impermissibly "switched" the rules on incumbent LECs, the appropriate focus of inquiry would be the impact of the 1996 Act and implementing regulations as a whole, not just of the individual regulatory decisions that the incumbents oppose. See *Colorado Springs Prod. Credit Ass'n* v. *Farm Credit Admin.*, 967 F.2d 648, 653 (D.C. Cir. 1992) (it is appropriate to consider the benefits and burdens of the "overall legislative 'transaction'" in assessing a takings claim). The 1996 Act confers significant benefits on Verizon and the other major incumbents by, for example, eliminating or reducing restrictions on their entry into the long-distance market in return for their compliance with Sections 251 and 252. See 47 U.S.C. 271 (prescribing method whereby Bell companies such as Verizon may obtain permission to enter long-distance market); 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (relieving GTE from restrictions on provision of long-distance service); see generally *BellSouth Corp.* v. *FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (describing benefits provided to incumbent LECs by the 1996 Act).[20] It is, moreover, implausible to assert, as Verizon now does, that the regulatory steps necessary to open monopoly markets to full competition have either taken them by surprise or left them with anything short of a robust return on their investments.[21]

---

[20] Pursuant to Section 271, the FCC has authorized Verizon entities to offer long distance services in New York and Massachusetts—activities that such entities were precluded from engaging in before the adoption of the 1996 Act. See *AT&T* v. *FCC*, 220 F.3d 607 (D.C. Cir. 2000); *Application of Verizon New England, Inc., et al. For Authorization To Provide In-Region, Inter-LATA Servs. in Massachusetts* (CC Docket No. 01-9), FCC 01-130 (Apr. 16, 2001), appeal pending *sub nom. WorldCom, Inc.* v. *FCC*, No. 01-1198 (D.C. Cir. filed Apr. 25, 2001).

[21] See Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999) (repudiating incumbents' claim of a breached "regulatory contract"); Jim Chen, *The Second Coming of Smyth v. Ames*, 77 Tex. L. Rev. 1535, 1566 (1999) ("The LECs' exhaustive knowledge of the laws, policy, and jurisprudence of regulated industries, compounded by their active lobbying before the passage of the Telecommunications Act, estops them from plausibly complaining of surprise, much less an unconstitutional violation of public faith.") (internal quotation marks omitted).

2. Relying on *Brooks-Scanlon Co.* v. *Railroad Commission*, 251 U.S. 396 (1920), Verizon contends that, in determining the "total effect" of a methodological decision for purposes of the *Duquesne* analysis, a regulator must disregard profits from lines of business outside that regulator's own jurisdiction. See Verizon Pet. Br. 33-34. Indeed, Verizon asserts, the FCC was required under *Brooks-Scanlon* "to set UNE [*i.e.*, network element] rates that would allow the UNE business to generate a sufficient return to stand on its own." *Id.* at 35. *Brooks-Scanlon* has no application to the circumstances here. In any event, whether or not it is appropriate under this Court's authorities to assess the incumbents' returns from the leasing of network elements in isolation, there is no reason to conclude that those returns are constitutionally inadequate under the FCC's methodology. That is because the inquiry required under the FCC's methodology—*i.e.*, the cost of obtaining the useful features of a network element in today's market—is closely analogous to an inquiry into fair market value. And fair market value is the touchstone for determining whether just compensation has been paid for private property taken for public use.

a. In *Brooks-Scanlon*, the Court held that a State could not force a company engaged in an *unregulated* "sawmill and lumber business" to operate an unprofitable railroad on the theory that the losses from the railroad would be offset by the profits from the sawmill and lumber business. 251 U.S. at 399.[22] No similar arrangement is at issue here. The "total

---

[22] The Court acknowledged, however, that if a company wished to continue operating a railroad pursuant to a state charter, the company could

effects" inquiry mandated by *Duquesne* should, at a minimum, permit consideration of a regulated firm's overall rate of return from all of its interrelated *regulated* activities. As to those activities, the appropriate question is whether a particular government policy requires the firm to "operate its *entire* business at a loss," for the firm is entitled only to "just compensation for [its] over-all services to the public." *Baltimore & Ohio R.R.* v. *United States*, 345 U.S. 146, 148-150 (1953) (emphasis added); see *Broad River Power Co.* v. *South Carolina*, 281 U.S. 537, 544 (1930) (*Brooks-Scanlon* simply prevents regulators from considering revenues from an unregulated business in assessing whether a regulated business may be abandoned as unprofitable).[23]

Verizon does not contend that the incumbent LECs are being required to operate their "entire [regulated] business" at a loss. Nor does Verizon contend that the incumbents are being compelled to operate those activities within the federal regulatory jurisdiction at an overall rate of return that is unconstitutionally low.[24] And for good reason. The available data demonstrate that the incumbents' interstate earnings

be required "to fulfil an obligation imposed by the charter even though fulfilment in that particular may cause a loss." 251 U.S. at 399.

[23] Although one passage in *Brooks-Scanlon* states that "[a] carrier cannot be compelled to carry on even a branch of business at a loss," 251 U.S. at 399, Judge Friendly correctly observed, even before *Duquesne*, that any such proposition is inconsistent with modern regulatory takings precedent and "is not the law." *In re Valuation Proceedings Under Sections 303(c) and 306 of the Reg'l Rail Reorganization Act*, 439 F. Supp. 1351, 1357 n.12 (Spec. Ct. 1977) (citing cases).

[24] Contrary to Verizon's suggestion (see Verizon Pet. Br. 34), the FCC considered only the incumbents' revenues from the federal jurisdiction in assessing the net effect of its decision to adopt TELRIC. See *Local Competition Order* (para. 737 & n.1756), J.A. 421 (citing *Smith* v. *Illinois Bell Tel. Co.*, 282 U.S. 133 (1930)). The FCC concluded that no incumbent had presented persuasive evidence that the application of TELRIC would have a significant impact on the financial integrity of its federally regulated activities. *Local Competition Order* (para. 738), J.A. 421-422.

have been robust and, if anything, have grown since the 1996 Act was enacted and implemented. See note 17, *supra*.[25]

b. Verizon's contention that the FCC's forward-looking cost methodology presents serious Takings Clause concerns fares no better if, as Verizon urges, the incumbents' compensation for leasing network elements is considered in isolation from their compensation for other regulated activities.

Under traditional just compensation principles, when the government commits private property to public use, it does not compensate the owner for its historical costs—*i.e.*, whatever amount the owner paid for the property in the past. Instead, the government pays the owner the fair market value of the property—*i.e.*, "what a willing buyer would pay in cash to a willing seller" in the current market. *United States* v. *Miller*, 317 U.S. 369, 374 (1943); accord *United States* v. *564.54 Acres of Land*, 441 U.S. 506, 513-514 (1979).

Fair market value is closely analogous to forward-looking cost. Where there is a fully competitive market for an item, its forward-looking cost (which includes a normal profit) approximates the going market price; where there is not (yet) a fully competitive market, ascertainment of an item's forward-looking cost requires a more direct inquiry into the current costs of replacing its useful functions. Either way

[25] Notwithstanding *Smith* v. *Illinois Bell Telephone Co.*, *supra*, it is arguable that, in the present context, no taking without just compensation could be found unless the incumbents demonstrate an inadequate return on the totality of their interrelated regulated activities, whether those activities are principally regulated by the federal government or by the States. The incumbents' facilities that are at issue here (*i.e.*, network elements) are used to provide services within the jurisdiction of each sovereign. And the incumbents' obligation to provide interconnection and network elements to new entrants at "just and reasonable" rates is neither strictly interstate service nor strictly intrastate service as those terms have traditionally been used. See *Iowa Utils. Bd. I*, 525 U.S. at 380 (recognizing that the local competition provisions of the 1996 Act "clearly 'apply' to intrastate service, and clearly confer 'Commission jurisdiction' over some matters").

the inquiry is conducted, the forward-looking cost of any item, like its fair market value, is affected by developments in technology, production, and other factors since the item was placed into service. In many cases, the forward-looking cost of an asset may exceed its fair market value, because the asset can be replaced in today's market only by one that has more sophisticated capabilities and therefore commands a higher price.

What Verizon seeks here, in contrast, is a compensation rule entitling incumbent LECs to recover the historical costs of their assets, even (or, perhaps, especially) when those costs far exceed the forward-looking cost and the fair market value of those assets. Nothing in this Court's Takings Clause jurisprudence compels such a result.

3. Verizon also invokes the notion of "stranded investment" to justify setting network element rates based on historical costs. Verizon claims that unspecified state or federal regulators, at some unspecified point in the past, compelled incumbent LECs to build facilities and then artificially slowed the incumbents' recovery of the costs of those facilities by extending the depreciation schedules beyond the facilities' economic lives (thereby maintaining low retail rates). Adoption of a ratemaking methodology based on forward-looking costs now, Verizon contends, would unconstitutionally deny incumbents the benefit of a putative regulatory bargain, under which they were supposedly guaranteed the eventual recovery of the full historical costs of those facilities. See Verizon Pet. Br. 4, 29-30. That claim fails for reasons already discussed and for additional reasons as well.

First, in *Duquesne*, this Court specifically held that a regulatory action that produces "stranded" investment—*i.e.*, investment for which a firm cannot recover its historical costs—does not violate the Takings Clauses unless the firm is left with an unconstitutionally low rate of return on the totality of its regulated activities. See pp. 28-29, *supra*. Verizon makes no such claim here. Instead, relying on cost

models developed for distinct universal service purposes[26] and on other off-point sources,[27] Verizon asserts that the application of TELRIC to determine network element rates would disallow roughly half of the existing regulated rate base. Verizon Pet. Br. 10-11. In the Order under review, the FCC reasonably rejected similar claims, because they were unsubstantiated and "unrealistically assume[d] that competitive entry would be instantaneous," whereas competition is, in fact, developing only gradually. *Local Competition Order* (paras. 688, 707), J.A. 385-386, 400-401. See *Southwestern Bell Tel. Co.* v. *FCC*, 153 F.3d 523, 541 (8th Cir. 1998) (noting the "relatively insignificant headway UNE purchasers have made in the telecommunications market"). In order for network element prices to cause stranded investment (even as a theoretical matter), an incumbent would have to lose a substantial share of its customers to a new entrant, and to do so before the investment has been recovered through existing mechanisms. As long as the incumbent retains a significant

---

[26] The FCC has explained that the universal service cost model "may not be appropriate * * * [for] determining prices for unbundled network elements." *In re Federal-State Joint Bd. on Universal Serv., Ninth Report and Order and Eighteenth Order on Reconsideration*, 14 F.C.C.R. 20,432 (para. 41 & n.125) (1999).

[27] Verizon cites various sources purporting to show that the costs of network elements are significantly lower under a forward-looking methodology than under a historical cost methodology. See Verizon Pet. Br. 10 nn.4 & 5. But those sources are inapposite. They make a comparison not between forward-looking costs and historical costs, but rather between forward-looking costs and retail revenues. Historical costs and retail revenues are not commensurable; retail revenues can be higher or lower than costs for reasons (*e.g.*, implicit subsidies and retail-specific costs) that have nothing to do with methodological differences in assigning costs to the underlying facilities. Even apart from that conceptual flaw, the figures cited by Verizon reflect only the incumbents' self-serving allegations in local competition litigation in 1996, soon after the *Local Competition Order* was issued and before the States had come close to completing forward-looking cost studies.

market share (as all of them still do), the incumbent continues to recover the costs of its investments through, among other things, access charges and local retail rates, which are not set under the TELRIC methodology.[28]

Second, Verizon has not attempted to demonstrate that incumbent LECs' facilities are, in fact, "underdepreciated" today. See *Local Competition Order* (paras. 738-739), J.A. 421-422. There is ample reason to conclude that they could not make such a showing. In light of curative measures adopted over the past 12 years, the FCC recently determined that incumbents' facilities are, as a general matter, no longer underdepreciated and, indeed, that "their depreciation reserves are at a historic high level of 51 percent of total plant" and increasing by "over $10 billion per year." *In re 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent LECs*, 15 F.C.C.R. 242 (para. 65) (1999); accord *In re Federal-State Joint Bd. on Universal Serv., Tenth Report and Order*, 14 F.C.C.R. 20,156 (para. 427) (1999); David Gabel & David I. Rosenbaum, *Who's Taking Whom: Some Comments And Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239, 265-267 (2000) (incumbents' claims of stranded investment are "spurious" because "the book value

[28] The FCC has acted to protect incumbents' access revenues from rapid erosion in the new regulatory regime. See *Competitive Telecomms. Ass'n* v. *FCC*, 117 F.3d 1068, 1073-1075 (8th Cir. 1997) (upholding transitional rules that allow the assessment of certain access charges against new entrants that lease network elements); *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996* (CC Docket No. 96-98), FCC 00-183 (June 2, 2000) (adopting rules that, pending further study, preserve incumbents' access revenues by denying new entrants access to loop and transport network element combinations unless they provide a significant amount of local exchange service in addition to any access services they might offer), petition for review pending *sub nom. Competitive Telecomms. Ass'n* v. *FCC*, No. 00-1272 (D.C. Cir. filed June 23, 2000).

of the [incumbents'] assets is significantly less than the market value of the assets").[29] Verizon does not mention that determination, much less attempt to refute it.[30]

Third, even the most basic factual premise of Verizon's "stranded investment" argument—that state regulators compelled, rather than simply approved, the investments at issue—is subject to considerable doubt. As Professor Hovenkamp has explained, "such situations must be regarded as the exception rather than the rule," because, "[i]n most cases, the instigator of expansion is the regulated firm itself." Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801, 822 (1999). More generally, Verizon's claims of a breached "regulatory contract" are largely fictitious. "In most circumstances," as Professor Hovenkamp has observed, "the utility investor's investment-backed expectations are not all that different from the expectations of the investor in an ordinary enterprise, who can almost never expect compensation for obsolescence and only rarely for changes in government policy." *Id.* at 834. Thus, "[g]iven that society has been debating the large costs and relatively small benefits of regulation for more than twenty-five years, one can hardly argue that perpetual freedom from competition must be a

[29] Verizon errs in broadly asserting that the forward-looking cost of an incumbent's assets necessarily would be "substantially below book value." Verizon Pet. Br. 29. If assets have been in service for some time and have been fully depreciated (although they still have a substantial useful life remaining), the assets would no longer have any book value. A forward-looking cost methodology would not take into account past cost recovery, but instead would seek to provide an opportunity for full recovery of the cost of replacing the assets' useful functions.

[30] In addition, the effect of any "underdepreciation" would most likely be offset by the incumbents' ample returns on investment, which have far exceeded the incumbents' cost of capital in recent years. See note 17, *supra* (describing incumbents' rates of return for 1999 and 2000). It is meaningless to examine depreciation in isolation from other variables in the compensation calculus, such as the cost of capital.

part of the investment-backed expectations of the utility shareholder." *Ibid.*

Finally, the FCC has not foreclosed the possibility of providing a remedy for stranded investment, if the need for such a remedy is demonstrated. The FCC has explained, however, that such a remedy would sensibly be implemented not through the rates that new entrants pay for network elements, but rather through a competitively neutral federal or state funding mechanism. See *Local Competition Order* (para. 739), J.A. 422. There is no logical reason to distort the prices of all network elements, and thereby warp the course of competition nationwide, simply to accommodate the incumbents' unsubstantiated claims that some facilities in some States may remain underdepreciated despite recent reforms.[31]

In sum, the doctrine of constitutional avoidance invoked by Verizon is properly applied only "to avoid *serious* constitutional doubts, not to eliminate all possible contentions that the statute *might* be unconstitutional." *Reno* v. *Flores*, 507 U.S. 292, 314 n.9 (1993) (internal citation omitted); cf. *Public Citizen* v. *United States Dep't of Justice*, 491 U.S. 440, 481 (1989) (Kennedy, J., concurring in judgment) (constitutional avoidance doctrine "should not be given too broad a scope lest a whole new range of Government action be proscribed by interpretive shadows cast by constitutional provisions

---

[31] Verizon suggests, in passing, that the FCC's implementation of Section 254 casts doubt on its implementation of Sections 251 and 252. See Verizon Pet. Br. 12-14. Verizon has forfeited any challenge to the FCC's implementation of Section 254. In *GTE Serv. Corp.* v. *FCC*, No. 99-1244, one of Verizon's corporate predecessors challenged the adequacy of federal universal service funding under Section 254. Shortly after we filed our brief on the merits, Verizon successfully moved to dismiss the case. See 121 S. Ct. 423 (2000). The underlying decision of the Fifth Circuit, rejecting all relevant challenges to the pace and nature of the FCC's implementation of Section 254, is thus now final and controlling. See *Texas Office of Public Util. Counsel* v. *FCC*, 183 F.3d 393 (5th Cir. 1999).

that might or might not invalidate it"). At most, Verizon has raised the possibility that TELRIC, after its implementation by state commissions in individual circumstances, might produce constitutionally inadequate compensation. Such speculation does not warrant application of the constitutional avoidance doctrine to defeat the FCC's reasonable construction of the 1996 Act.

II. THE FCC REASONABLY DETERMINED THAT A FORWARD-LOOKING COST METHODOLOGY MOST EFFECTIVELY IMPLEMENTS THE COMPETITIVE OBJECTIVES OF THE 1996 ACT AND IS ADMINISTRATIVELY WORKABLE

Verizon contends that the FCC's decision to adopt a forward-looking, rather than historical, cost methodology to determine rates at which incumbent LECs lease network elements fails in various respects to satisfy the reasoned decisionmaking standards of the Administrative Procedure Act, 5 U.S.C. 701 *et seq.* See Verizon Pet. Br. 44-49. Those challenges, too, are without merit.

1. A central premise underlying the 1996 Act is that it would make little economic sense to expect new entrants, particularly in the short term, to construct all of the telecommunications facilities that they might need in order to serve their customers. In some (but by no means all) circumstances, the economic and social costs of duplicating an incumbent's facilities would exceed the corresponding benefits: Significant resources would be expended, and needless disruptions would occur (*e.g.*, streets would be dug up, customers would be inconvenienced), without commensurate increase in the value or diversity of telecommunications services. For that reason, and to jump-start competition in local telecommunications markets, Congress directed the FCC to identify those elements that new entrants should be entitled to lease from incumbents at "cost." 47 U.S.C. 251(c)(3) and (d)(2), 252(d)(1).

The FCC determined that basing the rates for access to those elements on incumbents' historical costs, when those costs exceed forward-looking costs, would either keep new entrants out of the market altogether or impair their competitive position by inducing them to construct inefficient, duplicative facilities. See *Local Competition Order* (paras. 620, 672, 679, 705), J.A. 327-328, 375-376, 379-380, 398-399.[32] The FCC reasoned that either result would conflict with Congress's goals of bringing meaningful competition to local telecommunications markets on an accelerated basis, promoting the efficient use of existing network facilities (many of which embody enormous economies of scale and density), and encouraging potential competitors to make economically rational choices about whether, or how, to enter local markets. See *Local Competition Order* (paras. 679, 704-707), J.A. 379-380, 397-401.

That determination is entirely reasonable. A principal objective of setting compensation levels in regulated industries has always been to "restore * * * the price that would result through the mechanism of a truly competitive market." *Farmers Union Cent. Exch., Inc.* v. *FERC*, 734 F.2d 1486, 1510 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984). And, as courts and commentators have recognized, historical costs are "essentially irrelevant" to entry decisions in competitive markets, "since those costs are 'sunk' and unavoidable and are unaffected by the new production decision." *MCI Communications*, 708 F.2d at 1117. In attempting to saddle new entrants with an incumbent's own historical costs, Verizon asks this Court to ignore "[o]ne of the most important lessons of economics"—that "you should look at the marginal costs and marginal benefits of decisions

[32] Similarly, setting network element rates on the basis of historical costs, if those costs were *lower* than forward-looking costs, would encourage inefficient use of incumbents' facilities and deter the efficient construction of new competitive facilities.

and ignore past or sunk costs." Paul A. Samuelson & William D. Nordhaus, *Economics* 167 (16th ed. 1998).

Nor does the FCC's adoption of a forward-looking approach to costs in this proceeding constitute an arbitrary departure from the FCC's use of a historical approach to costs in other proceedings. See Verizon Pet. Br. 44-45, 47-48. The FCC did not simply change, without explanation, regulatory approaches that it had previously employed. Rather, as discussed above, the FCC explained that setting network elements rates based on forward-looking costs is the appropriate approach in the *new* competitive environment contemplated by the 1996 Act. The FCC's earlier decisions employing historical costs typically occurred in a monopoly environment in which opening markets to competition was not a primary goal.

Verizon thus errs in asserting that the FCC's rejection of a historical-cost methodology, on ground of economic inefficiency, is arbitrary given the FCC's earlier justification for price cap regulation as encouraging efficient operations. Verizon Pet. Br. 47-48. Although the FCC adopted price caps in part to provide incentives for incumbent LECs to act efficiently, the FCC did so in the pre-1996 Act regulatory environment. In that context, the FCC was concerned with balancing the interests of incumbents and their (largely captive) customers, not, as in the current context, with encouraging efficient competitive entry. It does not follow that efficiency levels that were appropriate for the former task are also appropriate for the latter task.[33] Similarly, when the

[33] Verizon also misconstrues the FCC's 1997 adjustment of the price cap productivity factor as reflecting a determination that incumbents were operating efficiently. But that adjustment was designed to measure the annual rate at which the incumbents' efficiency improvement exceeded that of the general economy. The FCC made no judgment about the reasonableness of the incumbents' underlying rates based on historical costs. See generally *In re Access Charge Reform, First Report and Order*, 12 F.C.C.R. 15,982 (paras. 289-290, 295) (1997), aff'd, *Southwestern Bell*

FCC chose a historical cost methodology for setting rates in the cable television context, the FCC was concerned with preventing a monopolist from charging excessive rates to its retail customers, not with setting the rates that an incumbent could charge competitors for use of its facilities during a transition to competition. See *Time Warner Entm't Co.* v. *FCC*, 56 F.3d 151, 179, 184-185 (D.C. Cir. 1995), cert. denied, 516 U.S. 1112 (1996); 47 U.S.C. 543(b) (1994).

2. Verizon further suggests that the use of forward-looking costs to set network element rates will discourage facilities-based competition, producing instead a proliferation of competitors providing service solely through use of the incumbent's facilities. Verizon Pet. Br. 48-49. That argument is without merit. To begin with, Verizon's professed policy concerns about the nature of the competition that incumbents may encounter are analytically unhinged from Verizon's legal challenge to the FCC's methodology for determining network element rates. Congress, not the FCC, made the basic decision to accelerate competition by giving new entrants the right to enter local markets by leasing certain elements in the incumbent's network rather than duplicating all such elements on their own. See 47 U.S.C. 251(c)(3) and (d)(2).[34] Even if (as Verizon suggests) there were some policy justification for giving new entrants additional incentives to invest immediately in more facilities of

Tel. Co. v. *FCC*, 153 F.3d 523 (8th Cir. 1998). On review, the D.C. Circuit did not find that the productivity adjustment was too demanding of incumbents, as Verizon suggests. Verizon Pet. Br. 47-48. The court found only that the productivity adjustment was inadequately supported in the record. See *USTA* v. *FCC*, 188 F.3d 521, 524-526 (D.C. Cir. 1999).

[34] Congress also authorized entry by resale of services purchased by new entrants from incumbents at wholesale prices. 47 U.S.C. 251(c)(4). The 1996 Act does not favor entry by one means over another. It does contemplate, however, that new entrants ultimately will develop at least some facilities of their own. See *Local Competition Order* (para. 12), J.A. 271-272.

their own, it would make little sense to accomplish that objective by forcing new entrants, in the circumstances in which they are entitled to lease elements, to pay rates based on whatever amounts happen to appear on an incumbent's accounting books. Those amounts would vary widely and arbitrarily from incumbent to incumbent, and could be higher or lower than the forward-looking costs of the elements at issue. The FCC's decision to reject that approach is reasonable.

Verizon's policy concerns are refuted, moreover, by industry developments under the new regulatory regime. Since 1996, network element rates have reflected forward-looking costs. See p. 21 note 12, *supra*. And, both before and after this Court's decision in *Iowa Utilities Board I*, new entrants have been able in many (but not all) contexts to lease the elements necessary to provide service to their customers, as some of them must in order to develop a customer base sufficient to support further capital investments. See *Iowa Utils. Bd. I*, 525 U.S. at 387-392. Yet, in many settings, extensive competition of any kind has yet to develop; incumbents still control approximately 93% of total local telecommunications lines, and much of the existing competition in local markets, particularly in business markets, is provided by carriers that have built or purchased facilities of their own, rather than leasing the facilities from incumbents.[35] Moreover, new entrants have strong inherent incentives to build their own facilities, so as to avoid having to deal with, and rely on, their chief competitors, the incumbents, in order to do business. See *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 817 (1997), aff'd in part and rev'd in part, *Iowa Utils Bd. I*, *supra*. Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 501 (2d ed. 1994); see also U.S. Pet.

[35] See *Local Telephone Competition: Status as of June 30, 2000* (Industry Analysis Division, FCC, 2000) (available at http://www.fcc.gov/ccb/stats [file name: LCOM1200.PDF]).

Br. 42-44 (describing practical difficulties encountered by new entrants in leasing network elements).

3. Verizon further argues that any forward-looking approach, which asks what it would cost to replace the functions of network facilities in today's market, is so "administratively unworkable" that the FCC lacks discretion to adopt it. Verizon Pet. Br. 44-48. That claim is unsound.

For decades, commentators have debated the relative merits of the historical cost approach (also known as the "prudent investment" rule) and a forward-looking alternative that focuses on replacement costs (also known as the "fair value" rule). That debate has not been resolved, and each approach has its champions.[36] In *Smyth* v. *Ames*, 169 U.S. 466 (1898), this Court held that the use of a "fair value" methodology in the ratemaking context was constitutionally compelled; although the Court later rescinded that requirement in *Hope Natural Gas*, 320 U.S. at 602, the Court has preserved that methodology as a regulatory option. Thus, in *Duquesne*, the Court declined to adopt the historical cost approach as a constitutional requirement, observing that such a result would "foreclose a return to some form of the fair value rule just as its practical problems may be diminishing." 488 U.S. at 316 & n.10. What Verizon asks of the Court, however, is a policy-laden judicial determination that such "practical problems" do foreclose a regulatory agency's discretion to adopt a forward-looking cost regime.

[36] Verizon cites the articles of commentators who support the incumbent LECs' challenge to TELRIC. For a sampling of the many articles on the other side of the issue, see Gabel & Rosenbaum, *supra*; Hovenkamp, *supra*; Chen, *supra*; William J. Baumol & Thomas W. Merrill, *Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Services To Rivals*, 73 N.Y.U. L. Rev. 1122 (1998); Jim Rossi, *The Irony Of Deregulatory Takings*, 77 Tex. L. Rev. 297 (1998); William J. Baumol & Thomas W. Merrill, *Deregulatory Takings, Breach Of The Regulatory Contract, And The Telecommunications Act of 1996*, 72 N.Y.U. L. Rev. 1037 (1997).

As one commentator has observed, the incumbents seek "Smyth v. Ames reborn, only in reverse"—a decision foreclosing what, as embodied in TELRIC, "is arguably the fair value rule at its theoretical best, a system of setting rates 'according to the actual present value of [utility] assets' so that rate regulation can more effectively 'mimic[] the operation of the competitive market.'" Jim Chen, *The Second Coming of Smyth v. Ames*, 77 Tex. L. Rev. 1535, 1561 (1999) (quoting *Duquesne*, 488 U.S. at 308).

In few, if any, contexts would the methodological discretion of a regulatory agency merit greater judicial deference than in this one. See generally *Iowa Utils. Bd. I*, 525 U.S. at 397; *Chevron*, 467 U.S. at 842-843. The FCC, after considering various approaches to setting network element rates, including the forward-looking approach recently adopted by several States, chose such an approach as the means of determining "cost" in an industry undergoing the transition from monopoly to competition. See *Local Competition Order* (paras. 704-711), J.A. 397-403. The FCC observed that, in that regulatory setting, a market-based, forward-looking approach to cost offers a variety of theoretical advantages over a historical cost approach. See *Local Competition Order* (paras. 620, 705), J.A. 327-328, 398-399. The FCC concluded that those advantages outweigh concerns—which, the FCC found, are largely refuted by practical experience—that a forward-looking methodology would be more indeterminate than the alternatives. See, *e.g.*, *Local Competition Order* (para. 681), J.A. 381. That decision is reasonable; nothing in the 1996 Act precludes it; and any policy-based revision of that decision should come from the FCC or from Congress, not from the federal courts.[37]

[37] Verizon incorrectly suggests that the workability of TELRIC is called into question by the amount of time that the FCC took to develop a forward-looking cost model in the universal service context. Verizon Pet. Br. 45-46. Section 252 contemplates that each state public utility com-

Indeed, Verizon's expressions of concern about the "administrative workability" of TELRIC ring hollow because any historical cost methodology would present significant administrative difficulties of its own. A historical cost methodology, no less than other cost methodologies, requires complex judgment calls about an appropriate rate of depreciation, the cost of capital, and a method for allocating joint and common costs to various aspects of the network. See, *e.g.*, *National Rural Telecom Ass'n*, 988 F.2d at 178; see generally *Duquesne*, 488 U.S. at 314 ("[t]he economic judgments required in rate proceedings are often hopelessly complex"). Similarly, TELRIC's inquiry into efficient technological alternatives may not be "any more hypothetical in nature than the judgments called for [under a historical cost approach] in determining whether or not capital costs, some of which were incurred decades ago, were 'prudently' made or are 'used and useful.'" Gable & Rosenbaum, *supra*, 52 Fed. Comm. L. J. at 254. Moreover, historical cost data in the telecommunications industry have tended to focus on an incumbent's revenue needs in other contexts, not on the proper level of compensation to incumbents for the competitive use of particular facilities; as a result, those data have traditionally been aggregated over large geographic areas,

---

mission will establish rates for network elements in its respective State. See 47 U.S.C. 252(c)(2). The state commissions have been doing so, using TELRIC or (during the period when the FCC's pricing rules were stayed or vacated) a similar methodology, for nearly five years. The alleged complexity of forward-looking cost methodologies thus has not proved a significant impediment to the state commissions' ability to carry out their responsibilities under the 1996 Act. In the universal service context, by contrast, the FCC has been given the task of administering a national program, which required the FCC itself to determine universal service subsidy levels for carriers in every State. See 47 U.S.C. 254(a)(2) and (e). Since the prospect of determining such subsidy levels through individualized proceedings was not practical for a single regulator, the FCC understandably devoted considerable time to developing a model that would eliminate the need for such proceedings.

typically covering the entire territory served by a single company within a State.[38] It could therefore be exceedingly difficult to use existing historical cost data to establish reliable historical cost figures for particular facilities, functions, or features that new entrants may seek to lease.

Finally, the theoretical and practical shortcomings of the historical cost approach were not well recognized when Justice Brandeis wrote his dissenting opinion supporting that approach in *Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-311 (1923), an opinion on which Verizon places considerable emphasis. The ensuing 75 years of experience have revealed not just the substantial indeterminacy of historical cost methodologies, but also their tendency to produce inefficient overinvestment and misallocation of resources See, *e.g.*, *National Rural Telecom Ass'n*, 988 F.2d at 178; Harvey Averch & Leland L. Johnson, *Behavior Of The Firm Under Regulatory Constraint*, 52 Am. Econ. Rev. 1052 (1962); Jean-Jacques Laffont & Jean Tirole, *Competition In Telecommunications* 38 (2000). Moreover, Justice Brandeis was addressing the use of such methodologies in the context for which they were designed: determining a utility's overall revenue requirements. He did not address the use of such costs in the quite different context presented here: determining compensation levels for the competitive use going forward of particular network facilities, in circumstances where the legislature has endorsed such use in order to accelerate the transition from monopoly to competition.

---

[38] See, *e.g.*, *In re Federal-State Joint Bd. on Universal Serv., Recommended Decision*, 12 F.C.C.R. 87, 230 (para. 270) (1996); *In re Federal-State Joint Bd. on Universal Serv., Report and Order*, 12 F.C.C.R. 8776, 8903 (para. 232) (1997).

CONCLUSION

The decision of the court of appeals should be affirmed insofar as it sustained the FCC's discretion to adopt a methodology based on forward-looking costs to determine the rates that incumbents are authorized to charge new entrants for interconnection and network elements.

Respectfully submitted.

BARBARA D. UNDERWOOD
Acting Solicitor General

JOHN M. NANNES
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

BARBARA MCDOWELL
Assistant to the Solicitor General

CATHERINE G. O'SULLIVAN
NANCY C. GARRISON
Attorneys

JOHN E. INGLE
Deputy Associate General Counsel

LAURENCE N. BOURNE
Counsel
Federal Communications Commission

JUNE 2001

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
APR 9 2001
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Respondents.

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF ON THE MERITS OF SPRINT CORPORATION IN SUPPORT OF PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

DAVID P. MURRAY
Counsel of Record
RANDY BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Whether the court of appeals erred in holding that Section 252(d)(1) of the Act forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining the interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies.

2. Whether Section 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

RULE 29.6 STATEMENT

In accordance with Rule 29.6 of the Rules of this Court, Sprint Corporation ("Sprint") states as follows:

> Sprint is a corporation organized for the purpose of engaging in telecommunications and related businesses and is publicly traded under the names Sprint FON and Sprint PCS. Sprint Communications Company L.P. is a wholly-owned subsidiary of Sprint. Deutsche Telekom and France Télécom, both of which have issued public stock, each own approximately a ten percent share of Sprint.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
PRELIMINARY STATEMENT	1
OPINIONS AND ORDERS BELOW	2
STATEMENT OF THE CASE	2
A. Background	2
B. The Act.	3
C. FCC Regulations.	4
1. Pricing Rules.	4
2. Network Combinations Rule	6
D. Judicial Review of the *Local Competition Order*.	6
1. The First Eighth Circuit Decision.	6
2. *IUB I*	7
3. The Eighth Circuit's Decision On Remand ("*IUB II*").	9
SUMMARY OF ARGUMENT	10
ARGUMENT	12
I. A COST METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST OF EXISTING TECHNOLOGY DOES NOT VIOLATE THE ACT.	13
A. Congress Did Not Foreclose A Cost Methodology Based On The Efficient Replacement Cost Of Existing Technology.	13

TABLE OF CONTENTS—Continued

	Page
B. The FCC's Efficient Network Configuration Rule Was Reasonable And Entitled To Deference.	16
C. The Eighth Circuit's Holding Is Internally Inconsistent, Economically Unsound, And Will Lead To Unintended Results That Thwart Congress' Goal Of Facilitating Competition.	19
II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS SERVES THE PRO-COMPETITIVE PURPOSES OF THE ACT AND DOES NOT VIOLATE THE LANGUAGE OF SECTION 251(c)(3).	21
A. This Court Has Previously Held That Section 251(c)(3) Is Ambiguous.	21
B. The Eighth Circuit Has Erred A Second Time In Holding That Section 251(c)(3) Unambiguously Requires New Entrants To Combine UNEs.	23
C. It Was Reasonable For the FCC To Promulgate A Regulation That Prevents ILECs From Engaging In An "Anti-competitive Practice."	24
CONCLUSION	26

TABLE OF AUTHORITIES

CASES	Page
AT&T Corp. v. FCC, 220 F.3d 607 (D.C. Cir. 2000)	15
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	12
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	20
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	6, 21
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	*passim*
MCI Telecomms. Corp. v. U S W. Communications, Inc., 204 F.3d 1262 (9th Cir.), *cert. denied*, 121 S. Ct. 504 (2000)	22
Market St. Ry. Co. v. Railroad Comm'n of Cal., 324 U.S. 548 (1945)	16
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	16
Regions Hosp. v. Shalala, 522 U.S. 448 (1998)	12
Southwestern Bell Tel. Co. v. Waller Creek Communications, Inc., 221 F.3d 812 (5th Cir. 2000)	22
Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000)	5
U S W. Communications, Inc. v. Hix, Civ. No. 97-D-152 (consol.), Order (D. Colo. June 26, 2000)	23

TABLE OF AUTHORITIES—Continued

	Page
U S W. Communications, Inc. v. MFS Intelenet, Inc., 193 F.3d 1112 (9th Cir. 1999), *cert. denied*, 120 S. Ct. 2741, *reh'g denied*, 121 S. Ct. 18 (2000)	22
AGENCY DECISIONS	
In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996)	*passim*
In re Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, 15 F.C.C.R. 3696 (1999)	25
STATUTES	
47 U.S.C. § 153(29)	15
47 U.S.C. § 201(b)	4
47 U.S.C. § 251(c)(2)-(4)	4
47 U.S.C. § 251(c)(3)	*passim*
47 U.S.C. § 251(d)(1)	4
47 U.S.C. § 252(d)(1)	*passim*
47 U.S.C. § 252(d)(1)(A)-(B)	14
47 U.S.C. § 252(d)(1)(A)(i)	4
47 U.S.C. § 252(d)(1)(B)	4
REGULATIONS	
47 C.F.R. § 51.315	6
47 C.F.R. § 51.315(b)	*passim*
47 C.F.R. § 51.315(c)	*passim*
47 C.F.R. § 51.315(c)-(f)	*passim*
47 C.F.R. § 51.505(b)(1)	*passim*
47 C.F.R. § 51.505(b)(2)	5
47 C.F.R. § 51.505(b)(3)	5
47 C.F.R. § 51.505(c)	5

TABLE OF AUTHORITIES—Continued

CONGRESSIONAL MATERIAL	Page
H.R. Conf. Rep. No. 104-230 (1996)	3
OTHER AUTHORITY	
Paul W. Garnett, *Forward-Looking Costing Methodologies and the Supreme Court's Takings Clause Jurisprudence*, 7 CommLaw Conspectus 119 (1999)	7

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.2 and 25.1, Respondent Sprint Corporation ("Sprint") respectfully submits this Brief on the Merits of Sprint Corporation in Support of Petitioners Federal Communications Commission ("FCC") and United States of America. This brief addresses the following questions:

- Whether the court of appeals erred in holding that 47 U.S.C. § 252(d)(1) (Telecommunications Act of 1996) forecloses the cost methodology adopted by the FCC, which is based on the efficient replacement cost of existing technology, for determining interconnection rates that new entrants into local telecommunications markets must pay incumbent local telephone companies.
- Whether 47 U.S.C. § 252(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task.

Supreme Court Order List (Jan. 22, 2001) at 3-4.[1]

---

[1] The Court also granted the petitions for a writ of certiorari with respect to the following question presented by Verizon Communications, Inc. and the other incumbent local exchange carriers: "Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's 'historical' costs into the rates that it may charge new entrants for access to its network elements." Sprint supports the decision of the court of appeals upholding the FCC's regulations and will file a Respondent's Brief On The Merits, in accordance with the briefing schedule ordered by the Court.

OPINIONS AND ORDERS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit is reported at 219 F.3d 744 and reprinted in the Petition for a Writ of Certiorari of the FCC and United States of America at 1a-43a.[2] This decision reviewed the First Report and Order, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (Aug. 8, 1996) ("*Local Competition Order*"), and accompanying regulations issued by the FCC. The *Local Competition Order* is reported at 11 F.C.C.R. 15,499. Relevant portions of the *Local Competition Order* are reprinted at JA 264-452. The regulations are codified at 47 C.F.R. §§ 51.1-51.809. Relevant portions of the codified regulations are reprinted at JA 49-56. The *Local Competition Order* and codified regulations implemented the Telecommunications Act of 1996 ("Act"), Pub. L. No. 104-104, 110 Stat. 56 (codified at 47 U.S.C. §§ 151-276). Relevant portions of the Act are reprinted at JA 9-48.

STATEMENT OF THE CASE

A. Background.

Unlike many of the private parties participating in these proceedings, Sprint has *both* local and long distance operations. The "long distance side" of Sprint, like other new entrants, is interested in obtaining nondiscriminatory access to the networks of the incumbent local exchange carrier ("incumbent LEC" or "ILEC") at rates that will facilitate Sprint's ability to compete for business in the local telephone markets. The "local side" of Sprint, like other ILECs, is interested in ensuring that its rights and obligations under the Act are rationally and uniformly elucidated, that it is fairly

[2] The Court has agreed to the submission of a deferred Joint Appendix ("JA").

compensated for sharing its local networks with new entrants, and that its operations are not unduly burdened. Sprint has participated both as a new entrant and as an ILEC in state-regulated arbitrations pursuant to Section 252 of the Act. These experiences have given Sprint a balanced perspective on the challenges of opening local telephone markets to competition while satisfying the divergent interests of new entrants and ILECs.

Sprint believes that the vacated FCC regulations strike the proper balance in implementing the Act's pro-competitive objectives. The vacated price regulation establishes a forward-looking, long-run methodology for pricing unbundled network elements ("UNEs") based on "the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." JA 51 ("Rule 505(b)(1)"). This methodology attempts to replicate prices that would prevail in a competitive environment while ensuring that the ILEC is compensated for the use of its network elements at prices reflecting what it would cost to replace the elements today. The vacated network combinations regulation requires that ILECs "perform the functions necessary to combine unbundled network elements in any manner, even if those elements are not ordinarily combined in the incumbent LEC's network." JA 49 ("Rule 315(c)"). This requirement is intended to ensure that new entrants have efficient and meaningful access to UNEs in order to offer competitive local services.

B. The Act.

The Act seeks to transform state-sanctioned local monopolies into fully competitive markets on a national scale. *See* H.R. Conf. Rep. No. 104-230, at 113 (1996) (the primary goal of the Act is to increase competition in both local and long distance telephone markets as swiftly as possible). Congress recognized the practical and economic

impediments that new entrants would face if forced to replicate all of the ILEC's existing local network infrastructure. Congress therefore established comprehensive requirements "intended to facilitate market entry." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999) ("*IUB I*"). "Foremost" among them is the ILEC's "obligation under [Section 251(c)] to share its network with competitors." *Id.* The Act provides three complementary avenues for new entrants to obtain access to an ILEC's network: (i) interconnection with an ILEC's existing local network; (ii) leasing UNEs of the ILEC's network, either alone or in combination; and (iii) reselling the ILEC's services. JA 12-13.

Section 251(c)(3), which is at issue here, imposes a duty on ILECs to provide "nondiscriminatory" access to UNEs. JA 13. New entrants may use the leased UNEs, alone or in combination with the new entrant's own network facilities, to offer new and different competitive local services. ILECs are to receive "just [and] reasonable" compensation for leasing UNEs, "based on the cost . . . of providing" the element, including a "reasonable profit." JA 13, 23.

C. FCC Regulations.

Congress expressly delegated to the FCC the authority to promulgate rules to implement the Act's requirements. JA 10, 14. The Act sets few limits on the FCC's exercise of this authority. As this Court has recognized, the key provisions of the Act are subject to multiple interpretations and Congress was "well aware" that these ambiguities would be resolved by the FCC. *IUB I*, 525 U.S. at 397. The FCC adopted its local competition rules on August 8, 1996. JA 264.

1. Pricing Rules.

The FCC promulgated a cost methodology for establishing UNE rates that attempts to replicate conditions in a competitive market, while fairly compensating ILECs for the

"cost" of providing the UNE. The FCC concluded that a "forward-looking long-run economic cost" approach would best accomplish these objectives. JA 375-376 (¶ 672). A forward-looking approach measures the cost today to build an efficient local network with the same capabilities. JA 398-399 (¶ 705). New entrants, which build new facilities using the lowest cost, most efficient technology available, set prices on that basis. In response to this competition, ILECs, likewise would replace existing facilities using the lowest cost, most efficient technology available.

Forward-looking cost methods have been widely accepted in the professional literature, were implemented by several state utility commissions prior to passage of the Act, *see* JA 334-336 (¶ 631 & nn.1508-14), and were used by numerous other regulatory agencies in analogous contexts, *see Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12 & 13 (5th Cir. 1999) (citing examples of agencies adopting forward-looking, most efficient technology methodologies to encourage competition), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000). The particular forward-looking approach adopted by the FCC is called "Total Element Long Run Incremental Cost" or "TELRIC." TELRIC ensures that ILECs recover the full forward-looking cost of leased UNEs by measuring the long-run, incremental cost of the network element based on: (i) the use of the "most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers," JA 51; (ii) the cost of capital, thus allowing ILECs to recover normal economic profit, *id.*; and (iii) the useful life of the element, as measured by its economic depreciation rate, *id.* In addition, TELRIC allows for a reasonable share of joint and common costs. JA 51-52.

2. Network Combinations Rule.

The FCC promulgated a network combinations rule to implement the requirement in Section 251(c)(3) that ILECs provide nondiscriminatory access to UNEs in a manner that allows new entrants to use those elements to offer competitive local services to customers. JA 49. The network combinations rule establishes two related requirements. 47 C.F.R. § 51.315(b) ("Rule 315(b)") prohibits the ILEC from separating elements already combined in its network. Rule 315(c) requires the ILEC to combine, at a new entrant's request, elements that are not already combined to the extent technically feasible. The FCC determined that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent." JA 296. The FCC found that as a result of these "practical difficulties," requesting carriers "would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets," if ILECs were not required to combine UNEs upon request. JA 295-297.

D. Judicial Review of the *Local Competition Order*.

1. The First Eighth Circuit Decision.

Challenges to the *Local Competition Order* were consolidated in the Eighth Circuit and first decided in 1997. Of relevance here, the Eighth Circuit invalidated the FCC's pricing rules—including Rule 505(b)(1)—holding that the Act gives state public utility commissions, not the FCC, general jurisdiction to interpret and implement the Act's pricing provisions. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 794-800 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999).[3]

[3] During the period when the FCC's pricing rules were vacated on jurisdictional grounds, the overwhelming majority of state commissions independently chose to adopt the TELRIC methodology. *See* Paul W. Garnett, *Forward-Looking Costing Methodologies and the Supreme Court's Takings Clause Jurisprudence*, 7 CommLaw Conspectus 119, 132 (1999) (at least 35 states announced their intent to adopt TELRIC).

The Eighth Circuit also invalidated Rule 315(b)-(f)—the network combinations rule—on the ground that it violated the plain terms of Section 251(c)(3) of the Act. *Id.* at 813. According to the Eighth Circuit, "Section 251(c)(3) requires an incumbent LEC to provide access to the elements of its network only on an unbundled (as opposed to a combined) basis." *Id.* The Eighth Circuit believed that the statute "*unambiguously* indicates that requesting carriers will combine the unbundled elements themselves" because "the Act requires incumbent LECs to provide elements in a manner that enables the competing carriers to combine them." *Id.* (emphasis added). The Eighth Circuit thus rejected the FCC's interpretation of Section 251(c)(3), holding that the statutory "language [cannot] be read to levy a duty on the incumbent LECs to do the actual combining of elements." *Id.*

2. *IUB I.*

In *IUB I*, this Court described the paramount role Congress gave the FCC to interpret and implement the Act and the limited circumstances under which federal courts may override the decisions of the FCC. The Court stated as follows:

> It would be gross understatement to say that the Telecommunications Act of 1996 is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. . . . The 1996 Act can be read to grant . . . "most promiscuous rights" to the FCC vis-à-vis the state commissions and to competing carriers vis-à-vis the incumbents—and the [FCC] has chosen in some instances to read it that way. But Congress is well aware that *the ambiguities it*

> *chooses to produce in a statute will be resolved by the implementing agency.* (citation omitted). We can only enforce the *clear limits* that the 1996 Act contains . . . .

IUB I, 525 U.S. at 397 (emphasis added).

This Court reversed numerous parts of the Eighth Circuit's decision. Among other things, the Court held that Section 201(b) of the Act gives the FCC jurisdiction to adopt rules to implement all of the Act's local competition provisions. *Id.* at 377-86. The Court reversed the Eighth Circuit's ruling that the FCC lacked the statutory authority to establish national pricing rules, reinstated the FCC's pricing rules, and remanded so that the Eighth Circuit could review the substantive challenges to those rules. *Id.* at 377-78.

This Court also addressed one aspect of the FCC's network combinations rule, Rule 315(b), which prohibits ILECs from separating requested network elements that the ILEC ordinarily combines. The Court rejected the Eighth Circuit's "plain language" argument, holding that Section 251(c)(3) is ambiguous. *Id.* at 395. The Court held that the term "unbundled" in Section 251(c)(3) could refer to separately priced assets as distinguished from "physically separated" assets. *Id.* at 394. Although the Act contemplates that elements may be requested and provided in discrete pieces, the Court held that the Act "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *Id.* (emphasis in original). The Court further found Rule 315(b) to be "entirely rational, finding its basis in § 251(c)(3)'s nondiscrimination requirement." *Id.* at 395. The Court accepted the FCC's explanation that the only reason an ILEC would disconnect previously connected elements over the objection of the new entrant would be to impose wasteful reconnection costs. The Court held that "[i]t is well within the bounds of the reasonable for the [FCC] to opt in favor of ensuring against an anticompetitive practice." *Id.*

3. The Eighth Circuit's Decision On Remand ("*IUB II*").

In July 2000, the Eighth Circuit issued its decision on remand. The Eighth Circuit found that the term "cost" in § 252(d)(1) is "ambiguous" and that the FCC was therefore authorized to interpret the term to allow for a forward-looking cost model. *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 751-52 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 11a). The Eighth Circuit further held that the FCC's "use of a forward-looking cost methodology was reasonable," noting that the FCC had explained its reasoning "in detail." *Id.* at 752 (FCC Pet. App. 12a).[4]

Despite affirming the use of a forward-looking price methodology, the Eighth Circuit invalidated a key component of the FCC's methodology that measures forward-looking costs "based on the use of the most efficient tele-communications technology currently available and the lowest cost network configuration." *Id.* at 749-50 (FCC Pet. App. 8a). The Eighth Circuit held that because Section 252(d)(1) states that an ILEC may charge a just and reasonable rate "based on the cost . . . of providing *the* . . . network element," Rule 505(b)(1) is contrary to "the plain meaning" of the statute. *Id.* at 750 (FCC Pet. App. 8a) (emphasis in original). According to the Eighth Circuit, Congress' use of the definite article "the" in Section 252(d)(1) necessarily refers to the actual facilities deployed by the ILEC and thus precludes a forward-looking

---

[4] The court also held that the doctrine of constitutional avoidance did not require the FCC to use a historical cost model, citing well established law that "a takings claims cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *IUB II*, 219 F.3d at 754 (FCC Pet. App. 17a). The court thus rejected as premature the incumbents' Takings Clause challenge to the TELRIC methodology. *Id.* (FCC Pet. App. 17a-18a)

methodology that calculates costs by reference to the most efficient technology and design choices. *Id.*

The Eighth Circuit also reaffirmed its prior invalidation of Rule 315(c)-(f), notwithstanding this Court's reinstatement of Rule 315(b). *Id.* at 759 (FCC Pet. App. 27a). The Eighth Circuit again held that Congress, in the second sentence of Section 251(c)(3), "has directly spoken on the issue of who shall combine previously uncombined network elements. It is the requesting carriers who shall 'combine such elements.'" *Id.* (FCC Pet. App. 28a-29a).

SUMMARY OF ARGUMENT

In *IUB I*, this Court noted that the Act is in many respects ambiguous and held that the FCC is entitled to deference in interpreting and implementing its local competition provisions. The Eighth Circuit on remand refused to accord such deference to the FCC's determinations that forward-looking costs should be measured based upon a "least cost, most efficient technology" (Rule 505(b)(1)), and that ILECs should be required to combine network elements not ordinarily combined in their networks upon request (Rule 315(c)-(f)). The Eighth Circuit reasoned that both challenged regulations violated the "plain meaning" of the Act. These holdings rest on overly restrictive readings of the Act that will thwart, rather than promote, local telephone competition.

Rule 505(b)(1)'s "efficient network configuration" requirement helps to ensure that prices for UNEs are set at rates that replicate a competitive market, compensating the ILEC for what it would cost to replace the elements in today's market. As an organization with both long distance and local operations, Sprint believes that Rule 505(b)(1) strikes a fair and reasonable balance and is consistent with the pro-competitive purposes of the Act. The Eighth Circuit erroneously believed the statutory language in Section 252 (d)(1) requiring that UNE rates be based on the cost of

providing "the" interconnection or network element unambiguously means that rates may only be based on the cost of the ILEC's existing network. This holding compensates ILECs based on the cost of replacing network equipment with the very same equipment, even if no rational firm would deploy such technology in a competitive marketplace. Such an outcome is unsatisfactory to Sprint's entire organization. If costs are set too high, it will preclude effective competition. If costs are set too low, it will send false signals to potential new entrants concerning efficient entry levels. Rule 505(b)(1) helps to avoid these adverse results by setting costs in a manner that most closely simulates those of a competitive market.

Rule 315(c)-(f)'s combinations requirement ensures that new entrants will have nondiscriminatory access to UNEs in a manner that permits them to provide competitive services. The Eighth Circuit erroneously believed that the statutory language "unambiguously" requires new entrants to "do the combining themselves." This Court has already rejected that interpretation of Section 251(c)(3), which, as the FCC found, would effectively preclude many new entrants from using UNEs to offer competitive services. Because an ILEC maintains control over its own network, it typically would be more efficient and less costly for the ILEC to perform the functions necessary to combine UNEs. In some instances, it may be practically impossible for a new entrant to combine UNEs located within the network of the ILEC. Under the FCC's rule, the ILEC would be compensated at cost-based rates for performing the functions necessary to combine the elements. Sprint knows of no reason why an ILEC would refuse to do so other than to impose unnecessary burdens and costs on the new entrant.

The Act is designed to benefit consumers by bringing rapid competition to local telephone services. The regulations vacated by the Eighth Circuit are rational measures that the

FCC deemed necessary to carry out Congress' mandate. The regulations should be restored.

ARGUMENT

This Court's review of the challenged FCC regulations should be highly deferential. Under the relevant standard, the FCC's implementing regulations should be upheld unless "Congress has . . . addressed the precise question at issue" and unambiguously foreclosed the FCC's choice, or the agency's reasoning was arbitrary. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43, 845 (1984) ("*Chevron*"); *IUB I*, 525 U.S. at 397 (pursuant to *Chevron*, courts are only to "enforce the clear limits that the [Telecommunications Act of 1996] contains"). In making these determinations, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *Chevron*, 467 U.S. at 844. "If the agency's reading [of a statute] fills a gap or defines a term in a reasonable way in light of the Legislature's design, we give that reading controlling weight, even if it is not the answer 'the court would have reached if the question initially had arisen in a judicial proceeding.'" *Regions Hosp. v. Shalala*, 522 U.S. 448, 457 (1998) (quoting *Chevron*, 467 U.S. at 843 n.11).

The Act, as this Court noted, "is in many important respects a model of ambiguity or indeed even self-contradiction" that imposes few restraints on the FCC's exercise of its implementing authority. *See IUB I*, 525 U.S. at 397 (the Act grants "most promiscuous rights" to the FCC); *see also id.* ("Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency."). The Eighth Circuit acknowledged that the Act contained ambiguities and that the responsibility for resolving them belongs to the FCC, not the courts. *IUB II*, 219 F.3d at 752 (FCC Pet. App. 11a-12a). Even so, the Eighth Circuit invalidated the pricing and network

combinations rules based on strained readings of the "plain language" of the statute, thereby improperly depriving the expert agency of its authority to implement the Act's objectives.

I. A COST METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST OF EXISTING TECHNOLOGY DOES NOT VIOLATE THE ACT.

A. Congress Did Not Foreclose A Cost Methodology Based On The Efficient Replacement Cost Of Existing Technology.

The Eighth Circuit recognized that "the term 'cost,' as it is used in [Section 252(d)(1)], is ambiguous and that Congress has not spoken directly on the meaning of the word in this context." *Id.* at 751 (FCC Pet. App. 11a). The Eighth Circuit thus held that "the FCC's use of a forward-looking cost methodology was reasonable," noting that in the *Local Competition Order*, "the FCC explained in detail its reason for selecting a forward-looking cost methodology to implement the new competitive goals of the Act." *Id.* at 752 (FCC Pet. App. 12a).

Despite correctly holding that Section 252(d)(1) is ambiguous with respect to what is meant by "cost," the Eighth Circuit erroneously concluded that Section 252(d)(1) *unambiguously* precludes the FCC from adopting a methodology that measures that cost by reference to an efficient network. "It is clear from the language of the statute," the court held, "that Congress intended the rates to be 'based on the cost . . . of providing *the* interconnection or network element' . . . not the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute for the actual item or element which will be furnished." *Id.* at 750 (FCC Pet. App. 8a-9a) (emphasis in original). The court then detailed its understanding of what

the Act mandates: "The new entrant competitor, in effect, piggybacks on the ILEC's existing facilities and equipment. It is the cost to the ILEC of providing that ride on those facilities that the statute permits the ILEC to recoup." *Id.* at 751 (FCC Pet. App. 9a). Accordingly, the Eighth Circuit concluded, Section 252(d)(1) requires that rates be calculated based on the forward-looking cost of the ILEC's *existing* network.

The Eighth Circuit misinterpreted Section 252(d)(1). The provision states, in pertinent part, that "the just and reasonable rate for the interconnection of facilities and equipment . . . and the just and reasonable rate for network elements" be based on the cost "of providing *the interconnection or network element* (whichever is applicable), and [] nondiscriminatory, and [] may include a reasonable profit." JA 23 (emphasis added). The use of "the" before the phrase "interconnection or network element" merely identifies the thing (interconnection or network element) to which the cost-based requirement applies. "The" does not carry—and should not be read necessarily to imply—some greater connotation that unambiguously limits the FCC's ability to determine a basic component of its methodology for determining UNE "cost."

A cost methodology based on the most efficient replacement cost of existing network elements comports with the Eighth Circuit's conclusion that Section 252(d)(1) mandates that rates be based on the cost of providing the actual network element used by a new entrant. A long-run methodology assumes a period long enough that all costs are variable. That is to say, the very nature of such a methodology assumes that all plant and equipment can be replaced. If all plant and equipment can be replaced, any rational firm would do so in the most efficient manner. The long-term, forward-looking cost of the original piece of equipment is the cost of the efficient, new equipment needed to replace it.

Rule 505(b)(1) thus correctly measures the cost of providing the actual network element or interconnection by asking what cost the ILEC or any other carrier would bear in the marketplace *today* to replace the functions at issue with efficient substitutes currently available on the market that could be used consistently with the location of the ILEC's existing wire centers. Although the Eighth Circuit agreed that Section 252(d)(1) could be reasonably interpreted to permit a forward-looking cost methodology, the court's strained emphasis on the word "the" in the provision precludes a key component that gives rational effect to that methodology. Given that the Act's pricing provisions "give rate-setting commissions broad methodological leeway; [and] say little about the 'method employed' to determine a particular rate," *see IUB I*, 525 U.S. at 423 (Breyer, J., dissenting in part), the FCC's use of the most efficient replacement cost in Rule 505(b)(1), as a component of its TELRIC methodology, should be given controlling weight.

The Eighth Circuit misconstrued the statutory language in another respect as well. The Eighth Circuit incorrectly presumed that, in considering the costs of efficient substitutes, regulators are determining the forward-looking cost of something other than the elements whose functions the new entrant seeks to obtain. The forward-looking cost of any asset necessarily turns on the cost of replacing its *functions* with currently available, efficient substitutes. The term "element" describes, at an appropriately high level of generality, the *class* of facilities (or "features, functions, and capabilities") associated with particular tasks within the network. 47 U.S.C. § 153(29); *IUB I*, 525 U.S. at 387. For example, fiber wires and copper wires, despite their technological differences, can both be used to provide the loop element. *Cf. AT&T Corp. v. FCC*, 220 F.3d 607, 618-19 (D.C. Cir. 2000) (reviewing relative merits of using optical fiber versus copper to determine forward-looking cost of loop element). Similarly, analog switches and digital switches can

both be used to provide the switching element. JA 310-311; 323-324 (¶¶ 380, 412). The Eighth Circuit's decision confines the term "element" to individual pieces of equipment. Consequently, the Eighth Circuit believed that the forward-looking inquiry should turn on the cost of replacing an ILEC's existing facilities in every physical particular—rather than the *function* of those facilities—regardless of whether a rational actor would construct such facilities in today's market. Nothing in the language of Section 252(d)(1) remotely compels the adoption of that long-discredited methodological approach. JA 383 (¶ 684) (recognizing that such an approach could produce rates "that reflect inefficient or obsolete network design and technology"); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., concurring in the judgment) (disparaging, as the *least* appropriate cost methodology, an inquiry into "what it would cost to reproduce the identical property"); *Market St. Ry. Co. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 567 (1945) (in rate-setting contexts it never has been held that state commissions must "fix rates on the present reproduction value of something no one would presently want to reproduce").

B. The FCC's Efficient Network Configuration Rule Was Reasonable And Entitled To Deference.

The FCC adopted TELRIC because, in its view, a methodology based on forward-looking economic costs should "drive retail prices to their competitive levels" by setting costs at levels firms would face in a competitive market. JA 379-380 (¶ 679). This "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." JA 333-334 (¶ 630). The FCC carefully evaluated alternatives to its TELRIC methodology, as well as more general objections to the use of forward-looking pricing. The

FCC also considered several variants of forward-looking pricing before determining that TELRIC is the most effective and fair means to implement the Act's pro-competitive goals.

In particular, the FCC rejected pricing based on the "historical" or "embedded" costs reflected on the ILECs' accounting books. The FCC recognized that these costs could be either higher or lower than forward-looking costs. JA 398-399 (¶ 705). The FCC reasoned that the use of historical costs in determining the rates paid by new entrants would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the [] Act." JA 399 (¶ 705). The FCC thus concluded that historical cost pricing would frustrate the Act's competitive objectives. JA 397-403 (¶¶ 704-711).

The FCC likewise declined to establish a formula that would estimate the "forward-looking" cost of the ILEC's existing network. JA 383 (¶ 684). This approach appears to most closely resemble the Eighth Circuit's decision. Because this approach would allow ILECs to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* In asking what it would cost to replace the functions that make an asset valuable, the FCC noted that a forward-looking methodology requires an inquiry into currently available substitutes—including assets that perform the same functions as the original asset, but that do not resemble the asset in all respects—because they embody more efficient technology than does the original asset. JA 382-384 (¶¶ 683-685).

The FCC did not, as the Eighth Circuit wrongly contends, base its TELRIC methodology on "some state of the art presently available technology ideally configured but neither deployed by the ILEC nor to be used by the competitor." *See IUB II*, 219 F.3d at 751 (FCC Pet. App. 10a). The FCC noted

that "[p]rices based on the least-cost, most efficient network design and technology replicate conditions in a highly competitive marketplace by not basing prices on existing network design and investments unless they represent the least-cost systems available for purchase . . . ." JA 383 (¶ 683). Even so, the FCC expressly declined to adopt a forward-looking methodology "based on the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry." *Id.* The FCC instead established a methodology "based on costs similar to those incurred by incumbents." JA 380 (¶ 679). The FCC accomplished this by determining that TELRIC should take as given the ILEC's existing wire centers. JA 383-384 (¶ 685). That pragmatic limitation has considerable significance for determining the rates that ILECs may charge, because it confines the inquiry to efficient alternatives that are compatible with the most basic geographic design of the existing network. By basing prices on efficient new technology that is compatible with the ILEC's actual wire center locations, the FCC's approach mitigates ILECs' concerns that a forward-looking pricing methodology ignores their existing infrastructure. In the FCC's words, "[t]his benchmark of forward-looking cost and existing network design *most closely represents the incremental costs that incumbents actually expect to incur in making network elements available to new entrants.*" JA 384 (¶ 685) (emphasis added). The FCC further determined that this limitation, by encouraging new entrants to reduce costs "by designing more efficient network configurations," would put to rest any concern that the use of a forward-looking cost methodology would leave new entrants with insufficient incentives to construct their own facilities. *Id.*

TELRIC thus encourages and facilitates efficient market entry. If the rates for network elements are set below forward-looking cost, new entrants might be deterred from building competing facilities. Moreover, some new entrants

would be induced to enter using network elements where it would not otherwise be economically efficient for them to do so. If the rates for network elements are set too high, however, competitive entry may never occur. That is because it is unlikely that new entrants will ever build completely ubiquitous local networks and consequently must rely, at least in part, on leased elements. Because new entrants would be unable to price their retail services at competitive levels, they would decline to enter the market at all. By designing a forward-looking cost methodology that simulates a competitive market, the FCC sought to ensure that the rates eventually produced by that methodology would encourage new entrants to build competing facilities without stifling competition from the outset. JA 383-384 (¶ 685). Rule 505(b)(1)'s network configuration requirement is a reasonable and necessary component of that methodology. The Rule should be reinstated under *Chevron*.

C. The Eighth Circuit's Holding Is Internally Inconsistent, Economically Unsound, And Will Lead To Unintended Results That Thwart Congress' Goal Of Facilitating Competition.

Contrary to the Eighth Circuit's suggestion, the more appropriate way to "deal[] with reality" in determining the forward-looking costs of network elements is to take current available alternatives into account, rather than ignore them. In competitive markets, the price that a firm would pay to lease particular facilities varies with the cost of obtaining the function of the facilities through some other means, including through the use of more efficient substitutes. A firm would not arbitrarily blind itself to the availability of such substitutes. Taking those substitutes fully into account is not "fantasizing about what might be," as the Eighth Circuit wrongly believed, but is a routine part of any sensible inquiry into the current value of an asset. Indeed, it would be irrational, in conducting such an inquiry, to *omit* consideration of the effective substitutes altogether and to proceed on

the assumption that technology has frozen in time and has no bearing on replacement costs.

Moreover, the Eighth Circuit's holding undermines Congress' goal of creating competitive market conditions as quickly as possible—a goal the Eighth Circuit itself recognized was advanced by a forward-looking cost methodology. If new competitors could enter the local market immediately by building ubiquitous networks, they would set prices based on forward-looking costs using the latest and most efficient technologies, and ILECs would be forced to follow suit. TELRIC achieves a similar result in the short term by allowing new entrants to lease parts of the existing network at their competitive market value. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) (forward-looking costs "mimic[] the operation of the competitive market"). The FCC's approach encourages the "*efficient* entry and utilization of the telecommunications infrastructure," JA 333 (¶ 630) (emphasis added), while sending the correct signals for entry, investment and innovation to producers, investors and consumers. By contrast, the Eighth Circuit's decision, which results in a cost methodology that attempts to calculate the cost to reproduce the identical equipment in the ILEC's network at today's cost, even if such a network would never be built today because the technology deployed is obsolete and inefficient, is essentially an embedded cost methodology.

Finally, the Eighth Circuit's holding could lead to unexpected results. The court's conclusion that "it is the cost to the ILEC of carrying the extra burden of the competitor's traffic that Congress entitled the ILECs to recover" suggests that the Act mandates a pure incremental cost methodology. This approach could result in a sweeping downward departure from the prices arrived at under TELRIC, providing inadequate compensation to ILECs and artificial incentives for new entrants to compete solely by leasing UNEs instead of establishing their own networks.

II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS SERVES THE PRO-COMPETITIVE PURPOSES OF THE ACT AND DOES NOT VIOLATE THE LANGUAGE OF SECTION 251(c)(3).

A. This Court Has Previously Held That Section 251(c)(3) Is Ambiguous.

Section 251(c)(3) imposes on ILECs:

> The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis .... An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

JA 13.

To implement this statutory provision, the FCC promulgated regulations that prohibited ILECs from separating already combined network elements requested by new entrants, JA 49, and that required ILECs to combine network elements that are not "ordinarily combined in the incumbent's network at a new entrant's request," *see id.*. The first time the Eighth Circuit reviewed the FCC's network combinations rule, it held that Section 251(c)(3) "requires an incumbent LEC to provide access to the elements of its network *only* on an unbundled (as opposed to a combined) basis" and "*unambiguously* indicates that requesting carriers will combine the unbundled elements themselves." *Iowa Utils. Bd. v. FCC*, 120 F.3d at 813 (emphasis added).

In *IUB I*, this Court rejected the Eighth Circuit's interpretation of Section 251(c)(3), holding that the statute was *ambiguous*. This Court held that Section 251(c)(3) "does

not say, or even remotely imply, that elements *must* be provided only [in discrete pieces] and never in combined form." *IUB I*, 525 U.S. at 394 (emphasis in original). The FCC's interpretation of "unbundled," this Court found, matched the only dictionary interpretation of that word: "'to give separate prices for equipment and supporting services.'" *Id.* (citation omitted). The Court thus deferred to the FCC's interpretation of Section 251(c)(3), finding that "[i]t was entirely reasonable for the [FCC] to find that the text does not command [the] conclusion" that the provision "contemplates the leasing of network elements in discrete pieces." *Id.* Moreover, the Court found that "[i]n the absence of Rule 315(b) . . . incumbents could impose wasteful costs on [new entrants]." *Id.* at 395. The Court held that the FCC was right to prohibit such "an anticompetitive practice." *Id.* at 394-95.

In light of this Court's decision, a number of federal courts have held that state commissions may impose terms in interconnection agreements requiring ILECs to combine previously uncombined UNEs. *See U S W. Communications, Inc. v. MFS Intelenet, Inc.*, 193 F.3d 1112, 1121 (9th Cir. 1999) ("It also necessarily follows from [this Court's decision in *IUB I*] that requiring [the ILEC] to combine unbundled network elements is not inconsistent with the Act: the . . . combination provision does not conflict with the Act because the Act does not say or imply that network elements may only be leased in discrete parts."), *cert. denied*, 120 S. Ct. 2741, *reh'g denied*, 121 S. Ct. 18 (2000); *MCI Telecomms. Corp. v. U S W. Communications, Inc.*, 204 F.3d 1262, 1268 (9th Cir.) ("The Supreme Court's interpretation of the Act makes absolutely clear that" a provision requiring combinations does not violate the Act.), *cert. denied*, 121 S. Ct. 504 (2000); *Southwestern Bell Tel. Co. v. Waller Creek Communications, Inc.*, 221 F.3d 812, 821 (5th Cir. 2000) ("There is nothing 'illegal' about the provision requiring [the ILEC] to combine network elements for [the new entrant]" because "[n]othing in the Telecommunications Act forbids such combinations."); *U S W. Communications, Inc. v. Hix*, Civ. No. 97-D-152 (consol.), Order at 13-14 (D. Colo. June 26, 2000) (interconnection agreement provisions "that require [the ILEC] to combine network elements at the request of new entrants are fully consistent with Section 251(c)(3) of the Act, as dispositively interpreted by the Supreme Court"). These courts upheld provisions requiring ILECs to combine UNEs as consistent with the Act and rejected the Eighth Circuit's conclusion that Section 251(c)(3) forecloses such a requirement.

B. The Eighth Circuit Has Erred A Second Time In Holding That Section 251(c)(3) Unambiguously Requires New Entrants To Combine UNEs.

On remand, the Eighth Circuit reaffirmed its earlier decision to invalidate Rule 315(c)-(f) based on the same "plain language" interpretation of Section 251(c)(3) that this Court rejected in *IUB I*. *IUB II*, 219 F.3d at 759 (FCC Pet. App. 27a). The Eighth Circuit focused on the phrase "in a manner that allows requesting carriers to combine" in concluding that the statute unambiguously requires new entrants to do the combining. *Id.* (FCC Pet. App. 28a-29a). This holding ignores the important implications of the Court's *IUB I* decision. In restoring Rule 315(b), this Court implicitly rejected an interpretation of Section 251(c)(3) that precludes ILECs from being required to provide UNE combinations. Rule 315(b) prevents ILECs from separating already combined UNEs, meaning that ILECs must provide those UNEs to new entrants in *combined* form. Requiring ILECs to combine previously uncombined UNEs upon request is the "flip-side" of prohibiting them from separating already combined UNEs. In both instances, combined UNEs are being provided. There is no basis to say that the statutory provision is unambiguous in requiring new entrants to combine UNEs in one context, yet ambiguous enough to require ILECs to provide UNE combinations in the other.

The Eighth Circuit's holding also fails to give full effect to the statutory language. Section 251(c)(3) obligates ILECs to provide UNEs "in a manner that allows requesting carriers to combine such elements in order to provide [a] telecommunications service." JA 13. The FCC correctly found that, in many instances, a requesting carrier would have no practical ability to combine elements on an ILEC's network or could only do so through cumbersome and wasteful efforts. If the statutory language were read as narrowly as the Eighth Circuit suggests, the provision would be rendered a nullity, since requesting carriers would be effectively deprived of the ability to use combined UNEs "in order to provide a telecommunications service." The FCC properly determined that an ILEC's statutory duty to provide UNEs in the manner contemplated by Congress may require that the ILEC do the actual combining. As the FCC explained, Section 251(c)(3)'s language "means that incumbents must provide unbundled elements in a way that *enables* requesting carriers to combine them to provide a service[; it] does not impose the obligation of physically combining elements exclusively on requesting carriers." JA 296 (¶ 294).

C. It Was Reasonable For the FCC To Promulgate A Regulation That Prevents ILECs From Engaging In An "Anti-competitive Practice."

Because Section 251(c)(3) is ambiguous, the Eighth Circuit should have deferred to the FCC's expertise in implementing the provision's requirements. *Accord IUB I*, 525 U.S. at 395, 397. Rule 315(c)-(f) ensures that new competitors are not "seriously and unfairly inhibited in their ability to use unbundled network elements to enter local markets." JA 296 (¶ 293). The FCC determined that a new entrant might lack sufficient information about the ILEC's network to be able to perform the combinations at all. In particular, the FCC noted

that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements from the incumbents' network without the assistance of the incumbent." *Id.*

These are the same types of competitive concerns that led this Court to reinstate Rule 315(b). The Eighth Circuit acknowledged that this Court's decision to reinstate Rule 315(b) "is rationally based on the nondiscrimination language in § 251(c)(3)," yet the Eighth Circuit never considered the potential for similar discriminatory or anticompetitive conduct as a reasonable justification for Rule 315(c)-(f). The only reason an ILEC would refuse to combine UNEs would be to impose unnecessary burdens and costs on new entrants. ILECs routinely combine UNEs and, because they control their networks, can do so much more efficiently than a new entrant. As long as the ILEC is fairly compensated for providing UNE combinations, there is no reason that new entrants—and ultimately their customers—should be forced to bear the additional costs, logistical delays, maintenance difficulties, and other burdens of attempting to combine elements on another carrier's network. These extra costs and delays, which ILECs do not suffer when serving their retail customers, would be pure economic waste borne exclusively by the new entrant, putting it at a substantial competitive disadvantage.

Recent developments illustrate the critical significance of Rule 315(c)-(f). The FCC has found that, in many contexts, "incumbent LECs have refused to provide access to network elements so that competitors could combine them." *In re Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. 3696, 3910 (¶ 482) (1999). Thus, as a practical matter, new entrants cannot simply take uncombined elements within the ILEC's network and combine them themselves. Absent a requirement that the ILEC do the combining, competitors in many instances will

not be able to use UNEs—the most promising of the Act's mechanisms for developing competition—to provide local service. Rule 315(c)-(f) should be restored.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court reinstate 47 C.F.R. § 51.505(b)(1) and 47 C.F.R. § 51.315(c)-(f).

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent Sprint Corporation

JUN 8 2001

Supreme Court, U.S.
JUN 8 2001
CLERK

Nos. 00-511, 00-555, 00-587, 00-590 & 00-602

IN THE

Supreme Court of the United States

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Petitioners,

v.

IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR RESPONDENT QWEST COMMUNICATIONS INTERNATIONAL, INC.

R. STEVEN DAVIS
LAWRENCE D. HUSS
SHARON J. DEVINE
ROBERT B. MCKENNA
QWEST COMMUNICATIONS INTERNATIONAL, INC.
1801 California Street
Denver, Colorado 80202
(303) 672-2861

WILLIAM T. LAKE
Counsel of Record
JOHN H. HARWOOD II
SAMIR C. JAIN
RUSSELL P. HANSER
SCOTT A. SHEPARD
WILMER, CUTLER & PICKERING
2445 M Street, N.W.
Washington, D.C. 20037-1420
(202) 663-6000

Counsel for Respondent Qwest Communications International, Inc.

June 8, 2001

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether an FCC rule concerning the rates an incumbent local telephone company may charge competitors for sharing its facilities is contrary to the Telecommunications Act of 1996 and arbitrary and capricious because the rule ignores the incumbent's real-world network and costs and instead sets rates based on an estimate of the costs that a hypothetical carrier would incur if it built and rebuilt a new ideal network using the least-cost, most efficient available technologies.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, respondent Qwest Communications International, Inc. states as follows:

Respondent Qwest Communications International, Inc. is a publicly held corporation that has no parent company. Through its operating subsidiaries, Qwest Communications International, Inc. provides broadband Internet-based data, voice, and image communications for business and consumers. No publicly held company owns ten percent or more of Qwest Communications International, Inc. stock.

U S WEST, Inc. merged with and into Respondent Qwest Communications International, Inc. on June 30, 2000. U S WEST, Inc. was formerly the parent and sole shareholder of U S WEST Communications, Inc. U S WEST Communications, Inc. was renamed Qwest Corporation on July 6, 2000. Qwest Corporation is a wholly owned subsidiary of Qwest Communications International, Inc. Qwest Corporation is a local exchange carrier that provides local exchange telecommunications, exchange access, information access, data services, wireless services, and intraLATA long distance services pursuant to tariff and contract.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

CORPORATE DISCLOSURE STATEMENT ii

TABLE OF AUTHORITIES v

OPINION BELOW 1

JURISDICTION 1

PERTINENT STATUTORY PROVISIONS 1

STATEMENT OF THE CASE 1

A. The Telecommunications Act of 1996 3

B. The FCC's Notice of Proposed Rulemaking 5

C. The FCC's Local Competition Order 7

D. Subsequent Proceedings 10

SUMMARY OF ARGUMENT 12

ARGUMENT 14

I. TELRIC IS FLATLY INCONSISTENT WITH THE TEXT OF THE STATUTE. 14

II. THE FCC'S METHODOLOGY IS NOT DEREGULATORY, CREATES ARTIFICIAL INCENTIVES, AND DISCOURAGES INVESTMENT, ALL IN DIRECT CONTRAVENTION OF THE ACT'S PURPOSES AND POLICY. 18

A. The FCC's Order Distorts Entry and Investment Incentives by Relying on Regulation Rather than the Marketplace. 21

B. The Order Creates Disincentives to Investment by Both CLECs and ILECs. 23

TABLE OF CONTENTS — Continued

III. THE FCC'S METHODOLOGY IS ARBITRARY AND CAPRICIOUS ON ITS OWN TERMS BECAUSE IT IS BASED ON ERRONEOUS ASSUMPTIONS THAT DO NOT REFLECT HOW REAL-WORLD MARKETS OPERATE. 29

IV. THE ACT PERMITS THE FCC TO IMPLEMENT OTHER FORWARD-LOOKING METHODOLOGIES MORE CONSISTENT WITH THE STATUTORY PURPOSES. 38

CONCLUSION 42

TABLE OF AUTHORITIES

CASES Page(s)

AT&T v. Iowa Utilities Board, 525 U.S. 366 (1999) .. *passim*
Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983) 37
California Dental Ass'n v. FTC, 526 U.S. 756 (1999) 17
Central Lincoln Peoples' Utility District v. Johnson, 735 F.2d 1101 (9th Cir. 1984) 38
Connecticut National Bank v. Germain, 503 U.S. 249 (1992) 15
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) 18
Iowa Utilities Board v. AT&T, 120 F.3d 753 (8th Cir. 1997) 10
Iowa Utilities Board v. FCC, 219 F.3d 744 (8th Cir. 2000) 1, 11, 12, 16
John Hancock Mutual Life Insurance Co. v. Harris Trust & Savings Bank, 510 U.S. 86 (1993) 18
MCI Communications Corp. v. AT&T, 708 F.2d 1081 (7th Cir. 1983) 36, 37
Neder v. United States, 527 U.S. 1 (1999) 18
Norwood v. FERC, 962 F.2d 20 (D.C. Cir. 1992) 38
Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984) 18
United States v. Wells, 519 U.S. 482 (1997) 15
Wisconsin v. FPC, 303 F.2d 380 (D.C. Cir. 1962), *aff'd*, 373 U.S. 294 (1963) 18

STATUTES

5 U.S.C. § 706 1
28 U.S.C. § 1254(1) 1
47 U.S.C. § 157 note 19
47 U.S.C. § 251 1
47 U.S.C. § 251(c)(1) 5, 22

TABLE OF AUTHORITIES — Continued

Page(s)

47 U.S.C. § 251(d)(2) 5, 28
47 U.S.C. § 252 2
47 U.S.C. § 252(a) 5
47 U.S.C. § 252(a)(1) 5, 22
47 U.S.C. § 252(b) 5, 22
47 U.S.C. § 252(c)(2) 4
47 U.S.C. § 252(c)(3) 4
47 U.S.C. § 252(c)(4) 4
47 U.S.C. § 252(d)(1) 2, 5, 14, 15
47 U.S.C. § 252(e)(2)(A) 5, 22
47 U.S.C. § 253(a) 3

RULES & REGULATIONS

47 C.F.R. §§ 51.501-51.511 1
47 C.F.R. § 51.505(b)(1) 2, 8, 14, 30
47 C.F.R. § 51.809 36

LEGISLATIVE MATERIALS

H.R. Conf. Rep. No. 104-458 (1996) 3, 4, 19, 20
H.R. Rep. No. 104-204 (1995) 16
S. Rep. No. 104-23 (1995) 16
Communications Law Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce, 104th Cong. 9 (1995) 20
141 Cong. Rec. 22,040 (1995) 20

ADMINISTRATIVE RULINGS

Access Charge Reform, First Report and Order, 12 FCC Rcd 15,982 (rel. May 16, 1997) 22

TABLE OF AUTHORITIES — Continued

Page(s)

Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987) 34, 37
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Notice of Proposed Rulemaking, 11 FCC Rcd 14,171 (rel. Apr. 19, 1996) 6
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, 11 FCC Rcd 15,499 (rel. Aug. 8, 1996) ..... *passim*
Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order, 15 FCC Rcd 3696 (rel. Nov. 5, 1999) *review pending, United States Telecom Ass'n v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir.) 11, 19, 26, 27, 28
Michigan Public Service Commission, *Re A Methodology to Determine Long Run Incremental Cost*, 156 P.U.R.4th 1, Exhibit A (1994) 6

BOOKS & ARTICLES

3A Philip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 773b2 (1996) 20
Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697 (1975) 37
William J. Baumol & Thomas W. Merrill, *Does the Constitution Require that We Kill the Competitive Goose? Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. Rev. 1122 (1998) 30, 31
William J. Baumol, *Economic Theory and Operations Analysis* (4th ed. 1977) 39

TABLE OF AUTHORITIES — Continued

Page(s)

William J. Baumol, Janusz A. Ordover, & Robert D. Willig, *Parity Pricing and Its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors*, 14 Yale J. Reg. 145 (1997) 33, 40

James C. Bonbright, Albert L. Danielsen & David R. Kamerschen, *Principles of Public Utility Rates* (2d ed. 1988) 22, 34, 38, 39

Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 Yale L.J. 417 (1999) 27

Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* (1998) 23, 41

Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (1988) 39

Alfred E. Kahn, Timothy Tardiff & Dennis L. Weisman, *The Telecommunications Act at three years: an economic evaluation of its implementation by the Federal Communications Commission*, 11 Info. Econ. & Pol'y 319 (1999) 24, 28, 31, 33, 35

Steven E. Landsburg, *Price Theory and Applications* (3d ed. 1995) 17

J. Robert Malko & Philip R. Swensen, *Pricing and the Electric Utility Industry* in *Public Utility Regulation: The Economic and Social Control of Industry* (1989) 38

Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (3d ed. 1950) 35

J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L.J. 1068 (1997) 30, 35

TABLE OF AUTHORITIES — Continued

Page(s)

J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements under the Telecommunications Act of 1996*, 97 Colum. L. Rev. 1081 (1997) 34, 40, 41

MISCELLANEOUS

Bell Atlantic Reply Comments, CC Dkt. No. 96-98 (May 30, 1996) 6, 7, 32

Black's Law Dictionary (6th ed. 1990)..... 17

Cox Communications Comments, CC Dkt. No. 96-98 (May 26, 1999) 27

GTE Comments, CC Dkt. No. 96-98 (May 16, 1996) 7, 18, 29, 30

MCI Comments, CC Dkt. No. 96-98 (May 16, 1996) 38

U S WEST Comments, CC Dkt. No. 96-98 (May 16, 1996) 33

OPINION BELOW

The opinion of the United States Court of Appeals is reported at 219 F.3d 744 and reprinted at pages 1a-43a of the Petitioner's Appendix in No. 00-511 ("Pet. App."). That opinion reviewed and vacated portions of the Federal Communications Commission's First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Dkt. No. 96-98 (rel. Aug. 8, 1996) (the "order"), and accompanying regulations. The order is reported at 11 FCC Rcd 15,499 and reprinted in relevant part at J.A. 264-452.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. The government filed its petition for a writ of certiorari in No. 00-587 on November 29, 2000. This Court granted that petition, and related petitions, on January 22, 2001, and has jurisdiction pursuant to 28 U.S.C. § 1254(1).

PERTINENT STATUTORY PROVISIONS

This case involves sections 251 and 252 of the Telecommunications Act of 1996, 47 U.S.C. §§ 251, 252, section 706 of the Administrative Procedure Act, 5 U.S.C. § 706, and Federal Communications Commission regulations codified at 47 C.F.R. §§ 51.501-51.511. These provisions are reprinted at Pet. App. 152a-177a.

STATEMENT OF THE CASE

This case concerns an issue that is central to the goal of the Telecommunications Act of 1996 ("1996 Act") to create real competition in the local telephone market: what prices incumbent local exchange carriers ("incumbents" or "ILECs") may charge when they are required to share their facilities with new competitive local exchange carriers ("CLECs"). Congress directed that these prices be based on the cost of providing the facility involved. The FCC, how-

ever, determined that these prices should be based on the totally theoretical cost of a newly constructed, idealized network that "use[s] the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1). The United States Court of Appeals for the Eighth Circuit vacated this pricing rule. That decision should be affirmed.

By passing the 1996 Act, Congress signaled its desire to foster, on a nationwide basis, what technological developments now permit: real competition between local telephone service providers. Congress specifically sought to encourage rival competitors to deploy alternative network facilities. At the same time, it recognized that, at least in the short term, new entrants would not be able to construct ubiquitous networks. Accordingly, Congress enabled entrants to lease individual pieces of the incumbents' facilities, called unbundled network elements or UNEs. Congress required that the prices for such UNEs be based on "the cost . . . of providing the . . . network element," 47 U.S.C. § 252(d)(1), and it charged the Federal Communications Commission ("FCC") with devising guidelines by which state public utility commissions would determine UNE prices.

The FCC adopted a forward-looking pricing methodology that it called TELRIC — short for total element long run incremental cost. That methodology does not attempt to determine the forward-looking costs that an *ILEC* will incur in providing an element. Rather, with a single unexplained exception, the FCC's methodology ignores altogether the ILEC's existing network and the iterative process by which an actual network is built. In its place, the methodology attempts to estimate the costs that a hypothetical carrier would incur if, each time a CLEC seeks to purchase a UNE, the hypothetical carrier instantaneously constructed an entirely new network using the least-cost, most-efficient available technologies and network configuration.

As the court of appeals held, while the FCC has discretion to determine the cost of providing an element using forward-looking costs, the 1996 Act does *not* give the agency authority to ignore altogether the ILEC's costs of providing an element. The FCC's mandate of the TELRIC methodology accordingly was a fatally flawed implementation of the Act. Whatever its role as a theoretical economic construct, TELRIC as applied by the FCC is so extreme that it significantly undermines the very purposes of the Act. In relying on such a methodology, the FCC thwarted the development of the real-world competitive process that Congress intended to permit, and instead created a marketplace distorted by artificial regulatory incentives concerning investment and entry. The FCC's TELRIC methodology cripples the incentives of CLECs and ILECs to invest in competitive facilities, and, contrary to the FCC's claim, fails to reflect how real-world markets operate. The court of appeals properly recognized that TELRIC therefore is directly contrary to Congress's intent, and that court's decision to vacate the portion of the FCC's rules that bases prices on a hypothetical, ideally efficient network should be affirmed.

A. The Telecommunications Act of 1996

The 1996 Act marked Congress's rejection of the premise that local telephone service is a natural monopoly. *See AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). Congress instead embraced the notion that technological advances have made local service competition possible. *See id.*; H.R. Conf. Rep. No. 104-458, at 113, 148 (1996) ("Conf. Rep."). It sought broadly to encourage that competition and the rollout of new advanced technologies in all telecommunications sectors and in all regions. *See* Conf. Rep. at 113. To achieve this objective, Congress ended the monopoly franchises previously granted by the states, preempting any state or local law that "may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." 47 U.S.C. § 253(a).

Congress recognized that, at least in the near term, new entrants in the local telephone market may be unable to deploy ubiquitous network facilities. *See* Conf. Rep. at 148. As a result, the Act provides three distinct routes by which a carrier can begin to offer competing local service without deploying a complete network. First, any carrier may, on request, interconnect its network facilities with the facilities of an incumbent LEC, allowing customers of different carriers seamlessly to call each other. *See* 47 U.S.C. § 251(c)(2). Second, CLECs may obtain access to selected pieces of the incumbent's network as unbundled network elements "at any technically feasible point . . . in a manner that allows requesting carriers to combine such elements in order to provide . . . telecommunications service." *Id.* § 251(c)(3). Third, CLECs may buy complete services from the incumbent at wholesale prices and resell those services. *See id.* § 251(c)(4).

The legislative history of the Act confirms that Congress believed that "meaningful facilities-based competition is possible." *See, e.g.*, Conf. Rep. at 148. It confirms, too, what the logic of the Act and basic economics suggest: Congress intended to encourage facilities-based competition no less than competition using UNEs or service resale. Congress sought "to provide . . . a pro-competitive, de-regulatory national policy framework designed to *accelerate . . . deployment of advanced telecommunications and information technologies* . . . by opening all telecommunications markets to competition." *Id.* at 113 (emphasis added); *id.* at 1 (the Act was intended to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies"). Thus, any interpretation that prefers competition by means of UNEs or resold services over facilities-based competition is a serious misreading of the Act.

Indeed, the Act places limits on the availability and pricing of UNEs precisely to ensure that CLECs' rights to use UNEs will not be so broad as to stifle the CLECs' incentives to deploy facilities of their own (or to stifle incentives for

ILECs to invest in new facilities). *See, e.g., Iowa Utils. Bd.*, 525 U.S. at 387-92 (relevant language "requires the FCC to apply *some* limiting standard, rationally related to the goals of the Act"). Not every network facility must be unbundled and provided to competing carriers. Congress charged the FCC with "determining what network elements should be made available." 47 U.S.C. § 251(d)(2). In fulfilling that charge,

> the Commission shall consider, at a minimum, whether—
>
> (A) access to such network elements as are proprietary in nature is *necessary*; and
> (B) the failure to provide access to such network elements would *impair* the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.

Id. (emphasis added). This mandate has come to be referred to as the "necessary and impair standard."

For UNE pricing, Congress relied first on incumbents and new entrants to negotiate prices in the context of broader interconnection agreements. *See id.* § 252(a). The statute allows carriers to bargain "without regard" to the Act's requirements, including the provision concerning pricing of UNEs. *Id.* §§ 251(c)(1), 252(a)(1), 252(e)(2)(A). Only if the parties cannot reach agreement may state commissions set UNE prices through arbitration proceedings. *See id.* § 252(b). Such UNE prices must be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element," must be "just and reasonable," and "may include a reasonable profit." *Id.* § 252(d)(1).

B. The FCC's Notice of Proposed Rulemaking

On April 19, 1996, the FCC released a notice of proposed rulemaking to implement the local competition provi-

sions of the Act. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Notice of Proposed Rulemaking, 11 FCC Rcd 14,171 (re. Apr. 19, 1996). The FCC posited that the UNE pricing provisions of the Act "appear[] to contemplate the use of . . . forms of cost-based price regulation, such as . . . the setting of prices based on a forward-looking cost methodology that does not involve the use of an embedded rate base, such as long-run incremental cost (LRIC)." *Id.* ¶ 123. It pointed to some state laws as examples of the model that it contemplated, *id.* ¶ 127, including a Michigan law requiring that the "[t]echnology used in a long-run incremental cost study should be the least-cost, most efficient technology that is currently available for purchase." *See* Michigan Public Service Commission, *Re A Methodology to Determine Long Run Incremental Cost*, 156 P.U.R.4th 1 (1994), Exhibit A. Under this principle, "the selection of the least cost technology is not based on the economics of adding to the current stock of telecommunications equipment providing service today, but rather assumes no equipment is currently in service and a completely new network is to be installed." *Id.* (internal quotations omitted).

Many commenters objected to the use of the pricing methodology contemplated by the FCC. They submitted testimony by economists such as Alfred Kahn and Timothy Tardiff, who challenged the premise "that the proper basis for the pricing of LEC services sold to competitors . . . is the . . . the total forward-looking cost of a hypothetical, ideally efficient system built by either the incumbent or some other carrier starting with a blank slate, using the most efficient current technology." Bell Atlantic Reply Comments, Kahn & Tardiff Decl. ¶ 8, CC Dkt. No. 96-98 (May 30, 1996). Kahn and Tardiff rejected the view that a "blank-slate" approach would mimic "the level to which competition would drive prices. . . . In a world of continuous technological progress, it would be irrational for firms constantly to update their facilities in order *completely* to incorporate today's lowest-cost technology, as though starting from scratch: investments

made today . . . would instantaneously be outdated tomorrow and, in consequence, never earn a return sufficient to justify the investments in the first place." *Id.* Kahn and Tardiff concluded that fostering the development of a real competitive marketplace requires that entrants be allowed to compete against the *ILEC's* costs, not those of a hypothetical, most efficient firm: "considerations of economic efficiency *require* that the prices charged to competitors be based upon the LECs' *actual* costs; to the extent competitors can provide these inputs more efficiently than the LECs, this will fully preserve their incentive to do so and thereby promote efficient facilities-based entry."[1] *Id.* (emphasis in original).

C. The FCC's Local Competition Order

The FCC released the order on review on August 8, 1996. In addressing which facilities ILECs must unbundle as UNEs, the order read the Act to "impose[] on an incumbent LEC the duty to provide *all* network elements for which it is *technically feasible* to provide access on an unbundled basis." J.A. 288, 292-93 (Order ¶¶ 278, 286-87) (emphasis added). The FCC "decline[d] to adopt" the view that the

---

[1] Other economic witnesses voiced similar concerns about the FCC's proposed model. As one noted, using such a model would guarantee that ILECs were always compensated at less than *their* forward-looking costs because, "[e]ven if actual . . . investment decisions were always completely efficient at the time they were made, improvements in technology will *always* guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place (or otherwise the older technology could be used in the hypothetical network)." GTE Comments, Hausman Aff. ¶ 14 n.4, CC Dkt. No. 96-98 (May 16, 1996) (emphasis in original); *see also id.* ¶ 3 ("Technological change will deprive LECs of recovering costs if rates are always measured on the basis of a forward-looking optimal network model."); GTE Comments, Crandall Decl. ¶¶ 15-16, CC Dkt. No. 96-98 (May 16, 1996) ("There are simply no market analogues for [the FCC's proposed model]. . . . Unfortunately, there is simply no evidence that such hypothetical networks would represent an efficient use of society's resources. If this were not the case, *someone would be building them.*") (emphasis in original).

necessary and impair standard requires it to consider whether a new entrant could obtain the requested element from a source other than the incumbent. *Id.* at 296-97, 299-300 (Order ¶¶ 283, 287). The order declared that *any* increase in cost or decrease in quality, no matter how trivial, would satisfy the impairment standard, on the ground that "requiring new entrants to duplicate unnecessarily *even a part of the incumbent's network* could generate delay and higher costs for new entrants, and thereby impede entry by competing local providers and delay competition, contrary to the goals of the 1996 Act." *Id.* at 296-97, 298 (Order ¶¶ 283, 285) (emphasis added). "The 1996 Act . . . does not impose *any* limitations on carriers' ability to obtain access to unbundled network elements." *Id.* at 312-13 (Order ¶ 329) (emphasis added).

The order then turned to the pricing of UNEs. It adhered to the FCC's proposal to base UNE rates on the theoretical forward-looking costs of an idealized hypothetical competitor. *See* J.A. 375-76, 397-401 (Order ¶¶ 672-73, 704-07). Notwithstanding the criticisms voiced in the comments, the agency essentially adopted the same model it had proposed. The FCC "coin[ed]" a new term, Total Element Long-Run Incremental Cost ("TELRIC"), for a model that purported to gauge the LRIC of network *elements*, rather than *services*.[2] *See id.* at 378-79 (Order ¶ 678).

The TELRIC methodology is expressly based on the "use of the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1); *see also* J.A. 382-84, 386-87 (Order ¶¶ 683-85, 690). In other words, by imagining a period "long enough so that all of a firm's costs become variable or avoidable," *id.* at 387, 397 (Order ¶¶ 677, 692), the model seeks to determine what a most efficient, least-cost network would look like if it were reconstructed from scratch at the time when UNE prices are being set, and then hypothesizing what the costs of that network would be. *See Iowa Utils. Bd.*, 525 U.S. at 374 n.3 ("TELRIC pricing is based upon the cost of operating a hypothetical network built with the most efficient technology available"). UNE prices are to reflect this idealized network's imagined costs.

[2] The FCC made this change on the assumption that elements are likely to have fewer joint and common costs than services. *See.* J.A.378-79 (Order ¶ 678). The order nevertheless acknowledges that incumbents still will have joint and common costs and that states may permit such costs to be recovered in UNE prices. *See id.* at 389-90 (Order ¶ 695).

The FCC acknowledged that a TELRIC methodology would "discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network" and therefore would have sharply reduced incentives to build their own facilities. J.A. 382-83 (Order ¶ 683). The FCC's only palliative was to allow the inclusion of one real-world factor: regulators would "assume that wire centers will be placed at the incumbent LEC's current wire center locations."[3] *Id.* at 383-84 (Order ¶ 685). The FCC's methodology ignores the actual location of all the other facilities in an ILEC's network and instead reconstructs the network based on the theoretically ideal locations for such facilities. The FCC said that its consideration of actual wire center locations would "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent LEC." *Id.* The FCC did *not* explain why the same rationale does not apply to the locations of ILEC network facilities other than wire centers — that is, why CLECs should be encouraged to invest in facilities only when they can locate wire centers more efficiently than the incumbent has and not when they can locate other parts of the network more efficiently. Nor

[3] A wire center is the physical location where subscriber lines connect to a switch.

did the FCC explain why its rationale does not apply when CLECs could employ more efficient technologies than the incumbent.

The agency did recognize that it *could* have based forward-looking costs "on incumbent LECs' existing network infrastructures, taking into account changes in depreciation and inflation." J.A. 382-83 (Order ¶¶ 683-84). But the agency rejected that approach in a single sentence, labeling it "essentially an embedded cost methodology." *Id.*

D. Subsequent Proceedings

Incumbent LECs and state commissions sought review of the order in the Eighth Circuit. That court held that the FCC lacked jurisdiction to adopt pricing rules, and it accordingly did not reach the merits of those rules. *See Iowa Utils. Bd. v. AT&T*, 120 F.3d 753, 800 (8th Cir. 1997). This Court reversed, holding "that the Commission has jurisdiction to design a pricing methodology." *Iowa Utils. Bd.*, 525 U.S. at 385.

This Court also rejected the FCC's conclusion that the necessary and impair standard imposes no limitations on a carrier's ability to obtain access to unbundled network elements. *See id.* at 387-91. The FCC's error in reading the standard sprang from its mistaken understanding that the Act empowers it to assume the existence of a perfectly competitive market for telecommunications services, an assumption similar to the theoretical perfection that underlies TELRIC. "In a world of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost (or decreased quality) with 'necessity' and 'impairment' might be reasonable; *but it has not established the existence of such an ideal world.*" *Id.* at 390 (emphasis added). Congress could have written language authorizing 'blanket access to incumbents' networks," but did not, and the FCC could not make up for the omission

by importing perfect competition assumptions found nowhere in the statute.[4] *Id.*

On remand, the court of appeals for the first time addressed the merits of TELRIC pricing. It upheld the FCC's decision to base prices on forward-looking rather than historical costs and rejected as unripe the takings challenge by ILECs to that decision. *See* Pet. App. 10a-18a. The court agreed with the FCC that the "the term 'cost,' as it is used in the statute [was] ambiguous," and it deferred to the FCC's choice of forward-looking costs. *Id.* at 11a-12a. But the court rejected the FCC's particular forward-looking cost approach. The court concluded that TELRIC, by completely divorcing the prices that an ILEC may charge for UNEs from the ILEC's costs of providing the elements, was directly contrary to the Act. The court ruled that UNE prices must instead be based on an ILEC's *own* forward-looking costs:

> Costs can be forward-looking in that they can be calculated to reflect what it will cost the ILEC in the future to furnish to the competitor those portions or capacities of the ILEC's facilities and equipment that the competitor will use including any system or component upgrading that the ILEC chooses to put in place for its own more efficient use. . . . At bottom . . . Congress has made it clear that it is the cost of providing the actual facilities and equipment that will be used by the competitor (and not some state of the art presently available technology ideally configured but neither deployed by the ILEC nor to be used by the competitor) which must be ascertained and determined.

---

[4] The FCC issued a new order interpreting the "necessary and impair" standard on remand. *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report and Order, 15 FCC Rcd 3696 (rel. Nov. 5, 1999) ("*UNE Remand Order*"). That order is under review yet again in the court of appeals. *See United States Telecom Ass'n v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir.).

Id. at 9a-10a.

As a result, while leaving intact much of the FCC's pricing regime, the court of appeals vacated the particular rule requiring that prices be based, not on the ILEC's costs, but on the costs that a hypothetical carrier would incur through "use of the most efficient telecommunications technology currently available and the lowest cost network configuration." *See id.* at 10a (vacating 47 C.F.R. § 51.505(b)(1)).

Several incumbents sought review of the court of appeals' rejection of historical costs. The FCC and a number of CLECs petitioned for certiorari to review the court's decision vacating the agency's rule basing UNE prices on a hypothetical most efficient network. This Court granted certiorari on both sets of pricing issues.[5] Qwest respectfully submits that the decision of the court of appeals to vacate the FCC's pricing rule should be affirmed.

SUMMARY OF ARGUMENT

The FCC's TELRIC methodology is inconsistent with the 1996 Act and arbitrary and capricious. The Act requires that UNE prices be based on the costs that an *ILEC* incurs in "providing" an element. The FCC instead based UNE rates on the costs that a *hypothetical carrier* would incur in using an ideally efficient network that never will exist and that the ILEC never will use to provide any element. Rather than foster the development of an actual competitive process, the FCC's order prescribes prices that correspond to the agency's guess at what the end result might be in a theoretical world of perfect competition and instantaneous deployment of new

---

5 The Court also granted the FCC's petition for certiorari to review the lower court's ruling on rules concerning the conditions under which ILECs could be required to combine UNEs. Qwest joins the separate Respondents' brief on that issue. *See* Brief for Respondents Verizon Entities, BellSouth Corp., SBC Communications, Inc., and United States Telecom Association (June 8, 2001).

technologies. This approach could not be more at odds with the language of the Act or its deregulatory purposes. It embodies the same error that this Court found infected the agency's reading of the "necessary and impair" test for unbundling: even if the FCC's reading might be reasonable "[i]n a world of perfect competition . . . it has not established the existence of such an ideal world." *Iowa Utils. Bd.*, 525 U.S. at 390. The FCC's ideal world is divorced from the actual market context in which carriers compete. It lowers *prices* without any corresponding decrease in *costs* and thereby distorts market signals and discourages investment in network facilities, contrary to the goals of the Act.

The FCC's methodology also is arbitrary and capricious on its own terms. The assumptions embodied in TELRIC about how a real-world competitive market works are simply wrong, especially where, as in the telecommunications sector, the market is capital-intensive and characterized by frequent cycles of innovation and declining costs. Carriers do not instantly and ubiquitously replace their network facilities every time a more efficient technology becomes available, nor do they immediately reduce their prices to the incremental costs of the new network. Instead, building a network is an iterative process. A carrier adjusts the capacity and location of network facilities as customer populations shift and grow, and it invests in new facilities only when the gap between prevailing prices and the costs of the new technology becomes sufficiently great to allow the carrier to price between those two levels and expect to earn a return on its investment. The utter failure of TELRIC to mimic the operation of a market explains why the FCC is unable to point to any instance in which such a methodology has been used to set prices in similar circumstances. The end result of the FCC's methodology is to ensure that the incumbent has no chance to recover its costs of providing network elements — a result in direct contravention of the Act.

Contrary to the suggestion by petitioners, rejection of the TELRIC model by no means requires the conclusion that the term "cost" has a "single meaning" or that the FCC lacks discretion in establishing pricing guidelines for UNEs. In place of the one rule vacated by the court of appeals, the FCC could use the "historical cost" model championed by Verizon or a model based in whole or part on forward-looking costs. But the court below properly concluded that the agency does not have discretion to adopt a methodology such as TELRIC that eschews the incumbent's costs altogether in favor of the agency's hypothesis of the costs of a nonexistent network built to serve perfectly estimated demand in the most efficient way conceivable with available technologies. That methodology is contrary to the statutory text and its animating purposes and is arbitrary and capricious.

ARGUMENT

I. TELRIC IS FLATLY INCONSISTENT WITH THE TEXT OF THE STATUTE.

Section 252(d)(1) provides that UNE rates "shall be . . . based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the . . . network element," shall be "just and reasonable," and "may include a reasonable profit." 47 U.S.C. § 252(d)(1). These provisions require that UNE prices be based on the costs that an ILEC will incur in providing a particular element. While the Act does not mandate a single methodology for determining those costs, it *does* limit the FCC's discretion by forging a relationship between the price an ILEC may charge for a UNE and the costs that the *ILEC* incurs in providing the UNE. TELRIC severs that relationship, and links UNE prices instead to the costs that would be incurred by a hypothetical competitor using "the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. § 51.505(b)(1). The Eighth Circuit correctly vacated this rule as inconsistent with the

text of section 252(d)(1), and this Court should affirm. *See, e.g., United States v. Wells*, 519 U.S. 482, 490 (1997) (natural reading of the full text is the "first criterion in the interpretive hierarchy" for statutes); *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

Section 252(d)(1) requires that UNE rates be "based on *the cost . . . of providing the* . . . network element." 47 U.S.C. § 252(d)(1) (emphasis added).[6] The FCC and its supporters focus on the term "cost" in isolation and assert that the ambiguity of that term gives the FCC virtually carte blanche discretion. *See* FCC Pet. Br. at 27-28; AT&T Pet. Br. at 29; WorldCom Pet. Br. at 25-26. But even assuming that "cost" itself may have different meanings, this does not imply that the term imposes no constraints at all, and the rest of the words in the statutory directive preclude the FCC's choice of TELRIC. First, by mandating that UNE rates be "based on the cost . . . of *providing*" an element, Congress directed the FCC to choose a methodology that measures the costs that the ILEC — which is doing the providing — incurs in providing elements. TELRIC, by contrast, bases UNE prices on the costs that a hypothetical carrier would theoretically incur in providing the element's functions over an imaginary network that uses only the most efficient technology and network layout available at all times. *See, e.g.*, J.A. 382-84 (Order ¶¶ 683-85). Since those hypothetical costs will never correspond to (and, indeed, will always be lower than) the costs that the ILEC incurs in providing the element, TELRIC does not produce a price "based on the cost . . . of providing" the UNE.

---

6 As the FCC has noted, the parenthetical term "determined without reference to a rate-of-return or other rate-based proceeding" does not "define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed." J.A. 397-98 (Order ¶ 704).

Second, as the court of appeals concluded below, by linking UNE prices to the cost of providing "*the* . . . network element," the statute focuses on the *actual* element or functionality that will be provided. *See* Pet. App. 7a-9a.[7] If Congress had intended UNE rates to reflect the costs of a hypothetical UNE that might be provided by a nonexistent carrier in a market where prices instantly reflect the most efficient technology available, it could have, and would have, used language to that effect. But Congress did not do so, and the FCC is not empowered to treat the statute as though it had.

The legislative history of section 252(d)(1) confirms that Congress intended UNE prices to correspond to the costs of the providing ILEC, not the costs of a hypothetical competitor. The House bill specified a pricing standard "requir[ing] that the costs *that a carrier incurs* in offering . . . unbundled . . . elements . . . shall be borne by the users of such . . . elements." H.R. Rep. No. 104-204, at 4 (1995) (emphasis added). The Senate Report likewise noted that the UNE pricing provision (then enumerated section 251(d)) "provides that any charge determined by the State through arbitration or intervention shall be based on the cost of *that* unbundled element and may include a reasonable profit." S. Rep. No. 104-23, at 21 (1995) (emphasis added). This language reinforces the text of the statute: section 252(d)(1) ties rates for a given element to the costs not of some hypothetical alternative, but of *that* element, in the *actual context* in which the ILEC will provide it. TELRIC ignores this clear congressional mandate.

Congress's intention that UNE prices relate to an ILEC's costs is further corroborated by the terms that Congress used

---

[7] This does not mean, as WorldCom suggests, that a unique price must be assigned to every individual switch or loop. *See* WorldCom Pet. Br. at 27-28. A regulator may choose to set a single average price for loops, or for loops within a particular geographic area, but that price must be based on the costs that the incumbent will incur in providing *its* loops.

elsewhere in section 252(d)(1). The statute directs that rates "may include a reasonable profit." Although this language gives regulators some discretion to decide whether or not to include a profit, they could not even *consider* the question unless the ratesetting mechanism took account of the ILEC's actual investments and expenditures. Time and again, courts, economists, and other authorities have construed the term "profit" to refer to the amount by which an entity's returns exceed its costs. *See, e.g.*, *California Dental Ass'n v. FTC*, 526 U.S. 756, 767 n.6 (1999) ("[A]ccording to a generally accepted definition 'profit' means gain from business or investment over and above expenditures, or gain made on business or investment where both receipts or payments are taken into account.") (internal quotations omitted); Steven E. Landsburg, *Price Theory and Applications* 782 (3d ed. 1995) (defining "profit" as "[t]he amount by which revenue exceeds costs"); Black's Law Dictionary 1211 (6th ed. 1990) (defining profit as the "[g]ain realized from business or investment over and above expenditures"). Indeed, the FCC's order here acknowledges that, "in plain English, profit is defined as 'the excess of returns over expenditure in a transaction or series of transactions.'" J.A. 393 (Order ¶ 699).[8]

By directing regulators to consider whether to include a "profit," Congress voiced its expectation that a UNE rate would be set based on an *ILEC*'s costs. TELRIC forecloses any potential for profit by setting UNE prices such that the ILEC has no chance to recoup its costs, even of *future* investments, except at a hypothetical instant at which every

---

[8] The FCC attempted to reconcile this definition of profit with its TELRIC standard by stating conclusorily that "[p]ossible accounting losses from the sale of . . . unbundled network elements using a reasonable forward-looking cost-based methodology do not necessarily indicate that incumbent LECs are being denied a 'reasonable profit' under the statute." J.A. 395 (Order ¶ 701). That assertion does not explain how a methodology that disregards everything about an incumbent's actual network can measure the incumbent's costs or, *a fortiori*, its return in excess of costs.

component of its facilities is the most efficient component available. *See, e.g.*, GTE Comments, Hausman Aff. ¶ 14. As discussed more fully below, *see* Part III, *infra*, that instant never will arrive in practice for any ILEC; and if it did, prices and costs would immediately diverge again as further technological advancements are reflected in lower UNE prices, even though neither the ILEC nor any competitor had implemented those advancements in its network.[9]

II. THE FCC'S METHODOLOGY IS NOT DEREGULATORY, CREATES ARTIFICIAL INCENTIVES, AND DISCOURAGES INVESTMENT, ALL IN DIRECT CONTRAVENTION OF THE ACT'S PURPOSES AND POLICY.

The FCC's TELRIC methodology also thwarts the Act's purposes and "frustrate[s] the policy that Congress sought to implement." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 143 (1984) (internal quotations omitted); *see also John Hancock Mut. Life Ins.*

---

[9] The statute's requirement that UNE rates be "just and reasonable" further cements the link between UNE rates and the ILEC's costs. Federal courts, including this Court, routinely have held that, to be "just and reasonable," rates must at least "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944); *see also Wisconsin v. FPC*, 303 F.2d 380, 388 (D.C. Cir. 1962) ("It is established by tradition and by many court decisions that for a public utility, rendering service by use of fixed equipment, a just and reasonable rate is one which returns a fair profit upon the investment, or which supplies the utility with adequate revenues to command needed funds upon an economically reasonable basis."), *aff'd*, 373 U.S. 294 (1963). By choosing a methodology that ensures ILECs will never recover their costs, the FCC has violated the settled meaning of the requirement that UNE prices be "just and reasonable." *Neder v. United States*, 527 U.S. 1, 21 (1999) ("[W]here Congress uses terms that have accumulated settled meaning under the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.") (internal quotation marks omitted).

Co. v. Harris Trust & Sav. Bank, 510 U.S. 86, 94-95 (1993) (agency construction must be consistent with statute's "object and policy"). Congress intended to deregulate local telecommunications and rely on market forces to encourage all participants to invest and innovate. Rather than encourage the development of an actual competitive *process*, the FCC prescribed prices it guessed would prevail in a perfectly competitive market in a theoretical world. In so doing, the FCC abandoned the deregulatory goals of the Act in favor of just another form of regulation that distorts the marketplace by deterring investment and facilities-based competition.

Congress intended sections 251 and 252 to serve the Act's objective of fostering a competitive marketplace. Ultimately, the statute is *deregulatory* in nature: Congress's objective was to create a competitive marketplace so that market forces would drive decisions about entry, investment, and pricing. *See, e.g.*, Conf. Rep. at 113 (Act creates a "deregulatory national policy framework"); J.A. 265 (Order ¶ 3) (Act is "deregulatory"). As the order itself observes, by passing the Act, Congress intended to "look to the market, not to regulation, for the answer." *Id.* at 271-72 (Order ¶ 12).

A critical part of Congress's deregulatory vision was to encourage investment in new facilities and technologies. As the FCC itself has recognized, a "fundamental goal of the Act is to promote investment and innovation by all participants in the telecommunications marketplace, and, in particular, to encourage rapid deployment of new telecommunications technologies." *UNE Remand Order*, 15 FCC Rcd at 3748, ¶ 110. Congress broadly mandated that "[t]he Commission and each State commission with regulatory jurisdiction over telecommunications services shall encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans" and "take immediate action to accelerate deployment of such capability by removing barriers to infrastructure investment." 47 U.S.C. § 157 note.

Congress believed that such infrastructure investment would lead to facilities-based competition in the local telecommunications market. The premise of the Act is that local telephone service is not a natural monopoly and that facilities-based competition is therefore both possible and desirable. *See Iowa Utils Bd.*, 525 U.S. at 371; Conf. Rep. at 148 (endorsing view that "meaningful facilities-based competition is possible").[10] Indeed, facilities-based competition is clearly preferable to competition based on UNEs: "[C]ompetition [is] increased by encouraging [firms] to [develop rival facilities], rather than taking the easier and less competitive course of obtaining access to another's facilities." 3A Philip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 773b2, at 203-04 (1996). As Justice Breyer observed, "[i]t is in the *un*shared, not in the shared, portions of the enterprise that meaningful competition would likely emerge." *Iowa Utils. Bd.*, 525 U.S. at 429 (Breyer, J., concurring in part and dissenting in part) (emphasis in original). Although the Act may not require the FCC to *favor* facilities-based competition over UNEs (and resale), at a minimum it requires that the FCC not erect artificial disincentives to that strategy. J.A. 271-72 (Order ¶ 12) ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.").

---

10 *See also* Conf. Rep. at 1 (passage of the Act would "accelerate rapidly private sector deployment of advanced telecommunications and information technologies"); *Communications Law Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Commerce*, 104th Cong. 9 (1995) (the Act "rightly stresses a need for facilities-based competitors to lead the way in providing a true alternative to today's monopoly in the local exchange service. In fact, it is no exaggeration to say that the entire bill is premised on the existence of robust facilities-based competitors.") (statement of Rep. Schaefer); 141 Cong. Rec. 22,040 (1995) (the Act is intended to "give[] new entrants the incentive to build their own local facilities-based networks, rather than simply repackaging and reselling the local services of the local telephone company") (statement of Rep. Goodlatte).

A. The FCC's Order Distorts Entry and Investment Incentives by Relying on Regulation Rather than the Marketplace.

The FCC's order defeats Congress's goal of fostering a deregulated competitive marketplace in which entry and investment decisions are based on market signals. Instead, the order uses regulation to *simulate* a theoretically perfect market through regulation — that is, it prescribes rates at levels that the agency theorized would prevail in a nonexistent, perfectly competitive market without regard to whether its actions would encourage or impede the development of a competitive process. J.A. 379-80 (Order ¶ 679). As Justice Breyer explained in *Iowa Utilities Board*, such an approach — far from deregulatory — simply substitutes one form of regulation for another: "[t]he competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any less a regulatory process, nor any the more a competitive one."[11] *Iowa Utils. Bd.*, 525 U.S. at 424

---

11 The FCC itself recognized this very distinction in an order released less than a year after the order at issue here. The agency rejected calls by carriers such as AT&T and WorldCom to prescribe the level of access charges (charges paid by long distance carriers to LECs to originate and terminate long distance calls) on the basis of forward-looking costs:

> We decide that adopting a primarily market-based approach to reforming access charges will better serve the public interest than attempting immediately to prescribe new rates for all interstate access services based on the long-run incremental cost or forward-looking incremental cost of interstate access services. Competitive markets are superior mechanisms for protecting consumers by ensuring that goods and services are provided to consumers in the most efficient manner possible and at prices that reflect the cost of production. . . . In addition, using a market-based approach should minimize the potential that regulation will create and maintain distortions in the

(Breyer, J., concurring in part and dissenting in part). Indeed, because the FCC's TELRIC methodology discourages investment in network facilities, *see infra* Part II.B, its methodology actually is a barrier to the development of a real competitive marketplace.

In setting UNE prices based on the assumption of a theoretically perfect market, the FCC committed much the same error that infected its determination that the statutory "impair" test was met by any increase in cost. *See* J.A. 292 (Order ¶ 285). As this Court explained in reversing that determination, "[i]n a world of perfect competition, in which all carriers are providing their service at marginal cost, the Commission's total equating of increased cost . . . with 'necessity' and 'impairment' might be reasonable; *but it has not established the existence of such an ideal world.*" *Iowa Utils. Bd.*, 525 U.S. at 390 (emphasis added). Likewise here, although UNE prices might tend toward some measure of incremental costs *in a world of perfect competition*, that is not this world. *See* James C. Bonbright, Albert L. Danielsen & David R. Kamerschen, *Principles of Public Utility Rates* 146 (2d ed. 1988) ("*Public Utility Rates*") ("[T]he concept of perfect competition makes no sense whatsoever" as a pricing standard.).

Finally, the FCC's methodology makes a nullity of the voluntary negotiation provisions of the Act. The statute allows carriers to engage in good-faith, private negotiations "without regard" to the Act's requirements, including the provision concerning pricing of UNEs. 47 U.S.C. §§ 251(c)(1), 252(a)(1), 252(e)(2)(A). Only if the parties cannot reach agreement may regulators set UNE prices. *See id.* § 252(b). But negotiations over UNE rates under these

---

investment decisions of competitors as they enter local telecommunications markets.

Access Charge Reform, First Report and Order, 12 FCC Rcd 15,982, 16,094, ¶ 263 (rel. May 16, 1997).

provisions are meaningless where the default price is set based on a hypothetical, idealized network and below any real-world price, as TELRIC mandates.

B. The Order Creates Disincentives to Investment by Both CLECs and ILECs.

The FCC's attempt to simulate a perfectly competitive market rather than foster an actual competitive process distorts market signals and suppresses the level of investment and innovation by ILECs and CLECs alike in direct contravention of Congress's intent.

1. In the case of CLECs, TELRIC discourages investment in at least three ways:

First, the methodology reduces the incentive of CLECs to invest, because, no matter how efficient, they by definition will never be able to invest at costs lower than the idealized TELRIC price for UNEs. Indeed, the order makes explicit that UNE prices should never exceed and "in most cases" will be below "the forward-looking cost that an efficient entrant would incur in providing a given element." J.A. 392 (Order ¶ 698); *see also* Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* 101 (1998) ("*Letting Go*") ("What is the point of a CLEC constructing its own facilities if it can lease or purchase them from the incumbent companies at the theoretically estimated *minimum* cost (let alone below that cost [as under TELRIC]) that would be incurred by a new entrant building from the ground up?").

The FCC's order gives CLECs the pricing benefits of cost-saving innovations where those innovations have not been implemented and costs have not actually declined. This mismatch between prices and costs distorts market signals and creates *disincentives* to the investment in facilities that actually would drive costs down to an efficient level:

> The economic purpose of prices set at incremental cost is to inform buyers — and make them pay —

> the cost that society will *actually* incur if they purchase more or would *actually* save if they reduced their purchases, entirely or partially. These can only be the costs of the supplier whose prices are being set, not some hypothetical ideal producer. Moreover, such prices give challengers the proper target at which to shoot — the proper standard to meet or beat and the proper reward if they succeed. If they can achieve costs lower than that, they will enter and *in the process* (which the FCC's pricing rules would omnisciently short-circuit) beat prices down to efficient levels. In contrast, TELRIC-based charges — if the FCC's apparent expectation that such rates would be lower than rates based on telephone companies' actual costs is correct — would actually discourage competitors coming in and building their own facilities . . . .

Alfred E. Kahn, Timothy Tardiff & Dennis L. Weisman, *The Telecommunications Act at three years: an economic evaluation of its implementation by the Federal Communications Commission*, 11 Info. Econ. & Pol'y 319, 330 (1999) ("*Economic Evaluation*") (emphasis in original).[12]

---

[12] This same mismatch of prices and costs explains the infirmity of petitioners' suggestion that failure to price elements at TELRIC will permit incumbents to engage in a "price squeeze." *See* WorldCom Pet. Br. at 11, 40; AT&T Pet. Br. at 18, 32. According to petitioners, if CLECs must buy UNEs at prices above TELRIC, they will have to price their services above TELRIC prices in order to recover their full costs. In the meantime, petitioners posit, incumbents will price their services at TELRIC and therefore will be able to squeeze the CLECs out of the market. *See* WorldCom Pet. Br. at 11. But this argument assumes that carriers are operating in a perfectly competitive market in which prices are at marginal costs and that the incumbent or some other seller is an ideally efficient carrier whose costs actually equal TELRIC. Of course, that is not the case. As long as the CLEC obtains an element from the ILEC at or below the ILEC's costs (as opposed to the TELRIC costs of a hypothetical competitor), there is no possibility of a price squeeze: both the CLEC and the ILEC must recover the same costs for that element in the retail price for the service. Indeed, if anything, TELRIC pricing puts *ILECs* in a price squeeze. Because a CLEC can obtain an element (or indeed, under the FCC's order, all the elements needed to provide a service) at the costs that would be incurred by an ideally efficient competitor, the CLEC can price below the costs of the ILEC, who — as petitioners insist, *see* FCC Pet. Br. at 28-29; AT&T Pet. Br. at 4, 18, 19, 33 — is not ideally efficient.

The order's uncoupling of UNE prices from costs is evident also in its faulty analysis of a CLEC's entry decision. The FCC states that its methodology focuses on "factors relevant to any carrier's present choices in a competitive market with respect to entry, expansion, and pricing." FCC Pet. Br. at 21. The agency observes that, all other things being equal, if a more efficient and less costly facility is available as a substitute for an incumbent's element, a rational entrant will not pay more than the cost of that substitute facility for the element. *See id.* at 22-23, 29. But the FCC follows with a non sequitur: that the price for the incumbent's less efficient element should be set at the cost of the more efficient substitute, since that is all a rational entrant would pay. Of course, if in fact a more efficient alternative facility is available, CLEC investment in that facility — and not purchase of the less efficient incumbent UNE at an artificially low price — will promote the development of competition. The FCC's methodology, however, strongly discourages such an investment from being made.

Second, TELRIC deters investment in facilities because investing in current technology exposes a CLEC to the very real risk that the mere availability of a still newer technology will instantaneously be reflected in the incumbent's UNE prices and put its own facilities at a competitive disadvantage as compared to CLECs relying on UNEs. To the extent that a CLEC does consider investing to install even today's most efficient technology, the CLEC (like the incumbent) will realize that it would be unable to recoup the investment, because the prices of the incumbent's UNEs would immedi-

ately reflect tomorrow's further innovations, even if nobody had invested to install them. Of course, a competitor in a capital-intensive market with rapidly evolving technologies and declining costs always must weigh the risk of obsolescence against the potential gain in efficiency that investing in the current technology may bring. But, under TELRIC, CLECs can gain the benefit while entirely avoiding the risk of obsolescence by relying on UNEs and the automatic reduction of UNE prices to reflect every technological advance. In so doing, the CLEC purchasing UNEs will obtain an artificial regulatory advantage over a CLEC that invests in its own facilities.

Third, TELRIC pricing discourages CLEC investment because it artificially expands the list of UNEs to encompass facilities the CLEC could self-provision or obtain from third parties at costs that, while above TELRIC, are lower than the incumbent's costs. As originally written, the FCC's order deemed the statutory "impair" test to be satisfied by *any* increase in cost that the CLEC would incur if it did not have access to the element in question. J.A. 292 (¶ 285). Not surprisingly, having defined the price of a element to be equal to the cost that a hypothetical, ideally efficient carrier would incur, the FCC found this test to be satisfied by every element it examined. In *Iowa Utilities Board*, this Court held that the FCC's interpretation drained the "impair" test of any substance and accordingly directed the FCC to impose a rational limiting standard. 525 U.S. at 387-91. On remand, the FCC has indicated that the impair test is met when there is a "material" difference in cost. *See UNE Remand Order* at 3725, ¶ 51. Whatever that may mean, it is clear that, because UNEs are priced at the incremental cost of an ideally efficient competitor, self-provisioning (or obtaining elements from third parties) will be "materially" more costly than unbundling even in situations where the CLEC could build or

obtain an element more efficiently than the ILEC.[13] And once that element is made available for unbundling, the CLEC will have little incentive to self-provision instead of leasing the element from the incumbent at the cost of an ideally efficient carrier it could not hope to outcompete.[14]

2. TELRIC pricing also undercuts *incumbents'* incentives to invest and innovate. As two prominent economists have explained, "[u]nder the FCC's TELRIC price regulation, if a new service is successful, a competitor can buy the service at its total . . . long-run incremental cost . . . . For a successful new service, the ILEC recovers at most its cost. For unsuccessful services, the ILEC recovers nothing and loses its sunk investment." Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 Yale L.J. 417, 459-60 (1999). As a result, "the expected return to the ILEC [for research and development costs] would always be negative," and "regulation would completely eliminate the economic incentive to provide the new service." *Id.*; *see also Iowa Utils. Bd.*, 525 U.S. at 429 (Breyer, J., concurring in part and dissenting in part) ("Nor can one guarantee that firms will undertake the investment necessary to produce complex technological innovations knowing that any com-

---

13 Indeed, with one exception, the FCC required unbundling of all the same elements as in its original order and then *expanded* the list to include additional elements. *See UNE Remand Order*, 15 FCC Rcd 3696 (rel. Nov. 5, 1999), *review pending*, *United States Telecom Ass'n v. FCC*, Nos. 00-1015 & 00-1025 (D.C. Cir.).

14 Of course, some CLECs have made substantial investments in facilities. But, as facilities-based CLECs told the FCC on remand from this Court, the FCC's unbundling rules, including TELRIC, suppress the amount of such investments. *See, e.g.*, Cox Communications Comments at 3, CC Dkt. No. 96-98 (May 26, 1999) ("A regulatory regime that fosters the broad availability of incrementally priced UNEs discourages competing carriers from building their own networks and leaves them dependent over the long term on the ILECs, to the detriment of the public interest.").

petitive advantage deriving from those innovations will be dissipated by the sharing requirement."); *Economic Evaluation* at 347-49 ("The notion that the ILECs are likely . . . to engage in . . . risky investments under a regulatory regime that requires them immediately to share those facilities with their competitors . . . at prices based on the FCC's efficient-firm cost standards is, quite simply, ludicrous.").[15]

In the end, even the FCC acknowledged the perverse investment incentives created by UNE prices based on a hypothetical, ideally efficient network. It conceded that such prices "discourage facilities-based competition by new entrants because new entrants can use the incumbent LEC's existing network based on the cost of a hypothetical least-cost, most efficient network" and therefore have little incentive to build their own facilities. J.A. 382-84 (Order ¶ 683). The FCC's "solution" was to make a single bow toward reality by adjusting its methodology so that the locations of incumbent's wire centers would be held constant. *See id.* at 383-84 (Order ¶ 685). This, the FCC said, will give CLECs an incentive to invest in facilities when and if they can use more efficient wire center locations. *See id.*

But the FCC failed to recognize the significance of this concession. It offered no explanation as to why it makes sense to encourage a CLEC to invest when it can choose a more efficient switch location than the ILEC, but not when it can be more efficient than the ILEC in any other way, whether by using a newer technology or by locating parts of

---

15 To be sure, incumbents may not be required to unbundle "proprietary" elements unless the FCC finds access to such elements to be "necessary." 47 U.S.C. § 251(d)(2). However, many innovations and investments are not "proprietary" and, in any event, the FCC has already indicated an intention to override the statutory "necessary" standard whenever it decides (based on entirely unspecified criteria) "that the incumbent LEC's asserted proprietary interest is outweighed by the benefits of facilitating more rapid deployment of competition for the greatest number of consumers." *UNE Remand Order* at 3718-19, ¶ 37.

its network other than switches more efficiently than the ILEC. In point of fact, if a CLEC can build or locate any network element more efficiently than the competing ILEC has done, costs are reduced when the CLEC invests in that element rather than continuing to rely on the less efficient and more costly (even if favorably *priced*) ILEC element.

In sum, the FCC's rule requiring UNE prices to be based on the cost of a hypothetical, ideally efficient network cannot be reconciled with the Act, because the rule contravenes Congress's goals of creating a deregulated competitive marketplace and encouraging investment in facilities by CLECs and ILECs alike. Accordingly, the court of appeals' decision to vacate the rule should be affirmed.

III. THE FCC'S METHODOLOGY IS ARBITRARY AND CAPRICIOUS ON ITS OWN TERMS BECAUSE IT IS BASED ON ERRONEOUS ASSUMPTIONS THAT DO NOT REFLECT HOW REAL-WORLD MARKETS OPERATE.

The FCC's TELRIC methodology is unlawful also because, although it purports to simulate the results of a competitive market, TELRIC relies on unsupported and inaccurate assumptions that fail to mimic how a real-world competitive market operates. The FCC's TELRIC methodology assumes that, (1) as soon as a new cost-saving technology becomes available, (2) a carrier will immediately install that technology throughout its service region without regard to its previously installed facilities, and (3) immediately reduce its prices completely to its new lower incremental costs. None of these assumptions holds in a competitive market, particularly in one such as telecommunications that is capital intensive and characterized by rapid technological change and declining costs. By basing UNE prices on these flawed assumptions, the FCC's methodology ensures that the incumbent will forever be required to charge less than it invested in its facilities and never will recover the costs of even new (let alone historical) investments. *See, e.g.*, GTE Comments,

Hausman Aff. ¶ 14 n.4 ("[I]mprovements in technology will *always* guarantee that a totally new, hypothetical, network will have a theoretical lower cost than the actual network in place . . . . Thus, basing cost on the current most efficient technology will impart a downward bias on estimates of actual network costs, causing an economic loss to the LECs . . . .").

"Available" Technologies. Requiring UNE prices to be based on the most efficient technology that is "currently available," as TELRIC does, 47 C.F.R. § 51.505(b)(1), is contrary to how prices are set in a competitive market. The mere availability of a new technology, whether in a lab or even in the channels of commerce, is not sufficient to drive prices down in a real-world competitive marketplace. *See* J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L.J. 1068, 1142 (1997). Rather, a new technology affects prices only if at least one competitor has installed it (or certainly will do so in the near future) in sufficient quantities to supply a significant portion of the relevant market. Even AT&T's expert has grudgingly conceded that "in a competitive market the availability of a small amount of less-costly improved equipment does not immediately lead to an equivalent reduction in the affected prices" and that the FCC's TELRIC methodology therefore may require some "readjustment." William J. Baumol & Thomas W. Merrill, *Does the Constitution Require that We Kill the Competitive Goose? Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. Rev. 1122, 1147 (1998); *see also* GTE Comments, Hausman Aff. ¶ 14 n.4 ("In a competitive market, a potential entrant could choose a new technology, but if the potential entrant decides not to enter, the hypothetical costs do not enter the pricing decisions," notwithstanding the availability of the new technology).

Ubiquitous and Immediate Deployment. The FCC's methodology also fails to reflect real-world markets because it bases, and lowers, UNE prices on the erroneous assumption that carriers operate in a perpetual greenfield. No carrier instantaneously installs a new network whenever a cost-saving innovation appears, as though it had no investment in existing facilities. Rather, even when a carrier decides to invest in a new technology, it generally does so incrementally, not ubiquitously throughout its network. For example, a carrier may use a new, more efficient loop technology first to extend service to a new neighborhood or development. But to assume (as the FCC's methodology does) that the carrier will simultaneously replace all existing loops in its network with the new technology belies reality. As Professor Kahn explains, TELRIC

> assume[s] in effect that the 'efficient firm' simply takes over the current volume of sales of the incumbent, sizing its plant to serve that demand at minimum cost. This assumption ignores the fact that many telecommunications assets are long-lived and that capacity is not deployed all at once, overnight, but expands incrementally to serve growing and changing demand. Ignoring the dynamic character of this process inherently understates the minimum costs of serving demand as it materializes in the real world, over time.

Economic Evaluation at 333-34; *see also* Baumol & Merrill, 73 N.Y.U. L. Rev. at 1147.

Firms systematically practice what economists term "anticipatory retardation." Rather than building a network from scratch to incorporate the newest technology the moment it becomes available, a firm invests in a new technology only when and where the cost of that technology is sufficiently below current prices that the firm can expect to earn a return on its investment in new assets over their economic lives. *See, e.g., Economic Evaluation* at 326. As a result, each carrier has capital plant of several vintages, with each vintage becoming outmoded over time as technological innovations permit lower costs. When the cost differential becomes suf-

ficiently great to justify making the investment needed to install a new technology in a particular location, the carrier does so and thereby achieves a cost advantage over other carriers whose plants have vintages that are in varying degrees less efficient than the new one.

Because no real-world carrier instantaneously installs a new technology throughout its network, the FCC's assumption of ubiquity artificially lowers UNE prices. Under the agency's methodology, each time the network is reconstructed to calculate UNE prices, the facilities hypothetically deployed have the perfect amount of capacity and are in the ideal locations given current and reasonably foreseeable demand. In the real world, of course, even efficient carriers do not have the benefit of such hindsight. They must project at the outset how much capacity they will need and where; then, if demand grows, they must increase capacity by, for example, adding modules to an existing switch — typically less efficient than buying a switch perfectly sized for the new output. *See* Bell Atlantic Reply Comments, Epstein Decl. ¶ 15 (TELRIC "imagines that in a competitive industry an efficient firm makes all the correct decisions on cost and design for the optimal network the first time out of the box, and has perfect foresight of how technology will develop. Stated in this form, the proposal offers a parody and not a description of a competitive industry.").

Moreover, the FCC's methodology posits a "bulk purchase" of the new facilities, when in fact carriers are likely to buy and install a new technology in much smaller increments with correspondingly higher costs (since they will not benefit from the same volume discounts). Finally, even when a new technology is installed, it lowers costs only in the particular location where the installation occurs. The airline industry illustrates this phenomenon. If a more efficient airline begins service on a route – say, from Richmond to Atlanta – and charges fares based on its lower costs, competitors may be forced to meet that reduced fare *on their Richmond to Atlanta*

flights. They are *not,* however, forced to match that fare throughout the rest of the country. Similarly, even in a fully competitive telecommunications market, if a carrier rolls out a new technology in a particular area, prices may begin to drop *in that area* (though, as discussed below, they will not fall to LRIC immediately), but not, as the FCC's TELRIC methodology assumes, everywhere at once.

Instantaneous Price Reduction. The FCC's methodology also erroneously assumes, again without explanation, the existence of a theoretically perfect market in which prices *immediately* reflect the full cost savings of a carrier's investment in a new lower-cost technology. But the opposite is true. A key incentive to install a new technology is to achieve a temporary cost advantage over competitors. *See, e.g., Economic Evaluation* at 348-49. As long as that cost advantage persists, the investing carrier can price sufficiently above its newly lowered costs to recoup its investment. When another carrier invests in a still newer and lower cost technology, the first carrier's cost advantage dissipates, and the second carrier achieves a cost advantage for a period of time (again pricing somewhere between the first carrier's costs and its own). *See, e.g.*, U S WEST Comments, Harris & Yao Aff. at 19, CC Dkt. No. 96-98 (May 16, 1996) ("[W]hat often occurs in competitive industries is that a production facility makes above average profits during its early years of operation, which decline over time until the firm is forced to upgrade or close down the production facility."). As this cycle of leapfrogging investment goes forward, each carrier has an opportunity to recoup its investments by pricing *above* its incremental costs, and thus has an incentive to invest. *See, e.g.*, William J. Baumol, Janusz A. Ordover, & Robert D. Willig, *Parity Pricing and Its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors*, 14 Yale J. Reg. 145, 160 (1997) ("[F]or each firm in a competitive market, the market price will cover the incremental cost of its product, a competitive return on the cost outlay, and *a bonus exactly equal to any*

relative cost savings that the efficiency of the firm permits it to contribute." (emphasis added)); *see also Public Utility Rates* at 154-55.[16]

This cycle will tend to drive prices down over time in response to cost-reducing innovations, but prices will not, as the FCC's methodology assumes, continuously drop all the way to the costs of the most efficient installed technology, particularly in an industry marked by rapid innovation cycles. To the contrary, the ability to price above cost is a key inducement to innovation and investment: Just as patent and intellectual property laws recognize that exclusive rights in

---

[16] To be sure, part of the return above incremental costs may represent recovery of joint and common costs not attributable to a particular service or element; and the FCC purports to permit states to make some provision for those costs. *See* J.A. 375-76, 377-78, 381-82, 390-91 (Order ¶¶ 672, 676, 682, 696). However, the recovery of such costs does not meet the need for some above-cost return to recoup an investment in new technology. Indeed, the FCC has asserted that joint and common costs in the case of unbundled elements (as distinguished from services) will be quite small. *See id.* at 378-79, 389-90 (Order ¶¶ 678, 695).

Moreover, the Order falls far short of ensuring that incumbents can recover joint and common costs. For example, it expressly forbids states to use so-called Ramsey pricing to allocate joint and common costs, under which costs are allocated in inverse proportion to demand elasticity so as to maximize the chance for recovery. *See id.* at 352-53, 390-91 (Order ¶¶ 645, 696). Economists generally accept the efficiency of Ramsey pricing, *see Iowa Utils. Bd.*, 525 U.S. at 426-27 (Breyer, J., concurring in part and dissenting in part); yet the FCC rejected it out of hand, J.A. 390-91 (Order ¶ 696). Indeed, even the Interstate Commerce Commission Coal Rate Guidelines, which the FCC holds up as a model, relied on the principle of Ramsey pricing. *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 526-27 (1985), *aff'd sub nom., Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987). Here, by contrast, the FCC actually approved the use of "reverse Ramsey pricing" for recovery of joint and common costs, which is both inefficient and almost certain not to permit full recovery. *See* J.A. 390-91 (Order ¶ 696); J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements under the Telecommunications Act of 1996*, 97 Colum. L. Rev. 1081, 1109-10 (1997).

an innovation for a period of time are a necessary inducement for innovation, the market rewards innovation by giving an innovator the opportunity to price above its costs to make a return on the innovation:

> If prices did not adjust gradually, there would be no incentive to engage in research and development or to invest in costly manufacturing to introduce any generation of products bearing new technology. . . . [B]ecause of lags, companies earn a return on the current technology in the interim period before the new technology becomes available; after the new technology is introduced, the development cycle continues. To imagine that prices fall immediately as a new technology is spotted over the horizon would be to eliminate any incentives for R&D and investment in production.

Sidak & Spulber, 72 N.Y.U. L.J. at 1142; *see also Economic Evaluation* at 348.

In short, at least in a market such as telecommunications that is characterized by successive cost-reducing innovations, incremental costs drop iteratively, and prices lag behind. As a result, the FCC's supposition that prices always and instantaneously equal incremental costs in a competitive market is simply wrong. *See* Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* 105 (3d ed. 1950) ("The introduction of new methods of production and new commodities is hardly conceivable with perfect — and perfectly prompt — competition from the start. And this means that the bulk of what we call economic progress is incompatible with it. As a matter of fact, perfect competition is and always has been temporarily suspended whenever anything new is being introduced . . . even in otherwise perfectly competitive conditions.").

At least one petitioner suggests that the FCC's model does not in practice assume that prices will instantly reflect

cost-saving technologies because interconnection contracts typically have three-year terms and so lock in prices for that period. *See* WorldCom Pet. Br. at 39. But this hardly corrects for the FCC's error. First, as noted, the FCC's methodology erroneously assumes that ILECs have incorporated the most efficient available technologies ubiquitously at the time the TELRIC methodology is employed. Second, an incumbent contracts with multiple CLECs at different times, and, under the FCC's methodology, the incumbent's network must be (figuratively) rebuilt every time. When this is coupled with the FCC's "pick and choose" rule, under which a CLEC can always opt into the favorable terms of another CLEC's subsequent interconnection agreement, *see* 47 C.F.R. § 51.809, the result is that technologies and prices are not locked in for the three-year term. Finally, even if TELRIC were applied only once every three years, it would still belie competitive reality, since no ILEC builds from a greenfield every three years.

The lack of connection between TELRIC and the operation of an actual market is further confirmed by the FCC's inability to point to any other instance in which a regulator has used the FCC's TELRIC methodology in similar circumstances — that is, to set prices in an environment marked by technological change in which the regulatory goal is not to *simulate* competition, but to *stimulate* competition by giving proper signals for investment. Petitioners note that incremental cost methodologies have been used by courts to set a price *floor* below which a price is deemed to be predatory for antitrust purposes. *See* AT&T Pet. Br. at 8, 29-30 (citing *MCI Communications Corp. v. AT&T*, 708 F.2d 1081, 1115-17, 1124-25 (7th Cir. 1983)); *see also* FCC Pet. Br. at 22. That makes perfect sense: a vendor would have little reason — other than predation — to price *below* its long run incremental costs, at least in a market (such as telecommunications) where incremental costs are generally decreasing. But to say that some measure of incremental cost represents a *floor* beneath which a party should not price does not justify

the use of incremental costs as a regulatory price *ceiling*.[17] Indeed, implicit in making LRIC a price floor is the recognition that in most situations competitors actually price *above* LRIC. As these cases recognize, when a party prices above LRIC, that creates an opportunity for a more efficient competitor to enter and undercut the incumbent. *See, e.g., MCI Corp.*, 708 F.2d at 1120. By mandating that UNE prices always be equal to TELRIC, the FCC creates a disincentive for such entry.

Petitioners also rely on a single instance in which the Interstate Commerce Commission used a LRIC-type methodology to set rates that could be charged to captive shippers for carrying coal by rail. *See* FCC Brief at 24 & n.9 (citing Ex Parte No. 347 (Sub-No. 1) *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-46 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444, 1451, 1457 (3d Cir. 1987)). That situation was critically different. In that proceeding, the shippers were captive and the regulatory goal was *not* to increase competition so that the shipper would have multiple choices. With competition unavailable, the second best solution was for the regulator to attempt to predict the price that the end user shipper would have to pay if the market were competitive. Here, by contrast, Congress's goal was to send appropriate market signals to encourage investment and entry by other carriers, so that no end user will be a captive and market forces will determine prices. Setting a price based on the hypothesized outcome in a perfectly competitive market with an ideally efficient car-

---

[17] Petitioners' reliance on predatory pricing cases is misleading in another respect: far from reflecting a consensus in support of a methodology similar to the FCC's, predatory pricing cases and literature are rife with conflicting views on the appropriate measure of costs for establishing a price floor. *See, e.g., Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 231-32 (1st Cir. 1983); Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697 (1975).

rier is fundamentally contrary to that statutory purpose. Instead — as Congress prescribed — prices should be based on the incumbent's actual costs, so that others will enter the market and invest in facilities to the extent they can do so more efficiently.[18]

IV. THE ACT PERMITS THE FCC TO IMPLEMENT OTHER FORWARD-LOOKING METHODOLOGIES MORE CONSISTENT WITH THE STATUTORY PURPOSES.

The FCC and its supporters are simply wrong when they portray the agency as having a very limited number of extreme choices in setting UNE prices. In point of fact, the agency could have chosen a variety of pricing methodologies that were consistent with the Act. As Verizon argues, pricing on the basis of historical costs would satisfy the terms of the

---

[18] LRIC-type methodologies have sometimes been used in the electricity industry. *See, e.g., Norwood v. FERC*, 962 F.2d 20, 21 (D.C. Cir. 1992); *Central Lincoln Peoples' Util. Dist. v. Johnson*, 735 F.2d 1101, 1116 (9th Cir. 1984); J. Robert Malko & Philip R. Swensen, *Pricing and the Electric Utility Industry* in *Public Utility Regulation: The Economic and Social Control of Industry* at 35-77 (1989). There, however, long run incremental costs generally are *increasing*. *See, e.g., Norwood*, 962 F.2d at 22; *Central Lincoln*, 735 F.2d at 1121-22. Thus, basing prices on a long run incremental cost methodology actually yields *greater* compensation to incumbents so that they can continue to invest and operate over the long run. The FCC and its allies suggest that it is unknown whether an ILEC's long run incremental costs will be higher or lower than its historic costs (that is, whether long run incremental costs are increasing or decreasing). *See, e.g.*, J.A. 398-99 (Order ¶ 705); Sprint Pet. Br. at 17. That is disingenuous at best. The FCC itself acknowledged in its order that historical costs are generally higher, as did commenters such as MCI; and petitioners' briefs are replete with assertions about the rapid pace of technological change in this industry. *See* J.A. 399-400 (Order ¶ 706); MCI Comments at 63, CC Dkt. No. 96-98 (May 16, 1996); AT&T Pet. Br. at 4, FCC Pet. Br. at 20. The lineup of the parties in this case leaves no doubt on this issue: CLECs would not be arguing for LRIC (and incumbents for historic costs) if they really thought historic costs were lower than LRIC.

statute. *See* Verizon Pet. Br. at 19-23. Moreover, contrary to the FCC's assertion that any attempt to measure an incumbent's own forward-looking costs amounts to an embedded cost methodology, *see* J.A. 383 (Order ¶ 684), the Act gives the agency discretion to consider other, more forward-looking techniques that avoid the infirmities of TELRIC.

As an initial matter, petitioners are wrong when they suggest that forward-looking costs must be either "long term," reflecting the time horizon at which all costs are variable, or "short term," taking all existing plant as fixed and including only variable costs, but nothing in between. J.A. 382-83 (Order ¶¶ 683-84); AT&T Pet. Br. at 17, 37-40; WorldCom Pet. Br. at 17. "Long term" and "short term" in this context are nothing more than the two ends of a continuum. *See* Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* 83-86 (1988). As economists recognize, "[i]n between these extreme cases, the very short and the very long run, there are all sorts of intermediate time periods in which the firm can make partial adjustments" so that some, but not all, costs that are fixed in the extreme short run become variable. William J. Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977); *see also Public Utility Rates* at 146-47, 423-24 ("[T]here is no point in assuming a greater degree of foresight than intelligent people can hope to enjoy at the time" of setting prices.).

The FCC could have calculated forward-looking costs over such an intermediate horizon (such as the three-or-four-year term of a typical arbitration agreement) and then included appropriate levels of fixed costs for any existing facilities that would remain in place during that time period and would be used to provide the element in question. *See, e.g., Public Utility Rates* at 423 (forward-looking incremental costs should be measured over "the next several years, from increases in rates of output to be accomplished by whatever plant additions and improvements will be warranted in view of the actual layout and actual capacity of the present plant").

In this manner, the UNE price would reflect the efficiency improvements and new technologies that the ILEC could expect to have in place and benefit from during the relevant future period; at the same time, the price would reflect the actual operational and depreciation expenses of the other facilities that would be used to provide the element. This would ensure that CLECs do not operate at a competitive disadvantage vis-a-vis the ILEC and would send appropriate economic signals: if a CLEC could provide the element more efficiently than the ILEC (taking into account the expected efficiency gains the ILEC would achieve during the term of the agreement on a forward-looking basis), the CLEC would have the proper incentive to invest in its own facilities.

The FCC also could have avoided at least some of the distorting effect of its methodology if it had truly relied on a Total *Element* LRIC approach, rather than what amounts to a Total *Network* LRIC methodology. In other words, when pricing an element, the relevant increment could be the total supply of the element in question, with the remainder of the network held constant, in the same way that the FCC held wire center locations, but nothing else, constant. This would, for example, recognize the reality that any existing service provider looking to invest in a new facility must take account of constraints imposed by its other facilities.[19]

The FCC could have chosen the efficient component pricing rule ("ECPR") methodology advocated by numerous economists. *See, e.g.*, Sidak & Spulber, 97 Colum. L. Rev. at 1093-99; Baumol, Ordover, & Willig, 14 Yale J. Reg. at 149-54. This forward-looking methodology is competitively neu-

[19] Consider, for example, a person considering the purchase of a word processing program. Suppose Word 8.0 is the most cost-efficient program in an abstract sense but requires Windows 2000 to operate, while Word 6.0 is less efficient but works with Windows 95. If the person has a computer with Windows 95 and will not replace it within the relevant time frame, the forward-looking cost for word processing should be the cost of Word 6.0.

tral and recognizes the economic reality that, in a real-world competitive market, the price for which a facility would be leased is based not only on its incremental costs but also on foregone opportunity costs. As Justice Breyer noted, "[t]he FCC rejected that system, but in doing so it did not claim, nor did its reasoning support the claim, that the use of such a system would be arbitrary or unreasonable." *Iowa Utils. Bd.*, 525 U.S. at 426 (concurring in part and dissenting in part); *see also* Sidak & Spulber, 97 Colum. L. Rev. at 1094-97 (explaining errors in FCC's discussion of ECPR).

The FCC also could have used a price cap model, as it and other agencies have done in other contexts. UNE prices would be based initially on historical costs or current prices but then reduced over time by an appropriate factor reflecting general improvements in productivity. *See Letting Go* at 95-96. Such an approach would give incumbents the incentive to innovate and invest, while at the same time giving CLECs reason to invest in their own facilities whenever they could provide the same element more efficiently than the incumbent (taking into account the reduction in price resulting from the productivity factor).

Neither the Act nor the court of appeals' decision requires the FCC to adopt any particular one of these or other possible approaches. Consideration of the alternatives is for the agency in the first instance. However, the FCC and its supporters are simply wrong in suggesting that the agency is faced with a limited choice between extreme approaches. The FCC remains free to consider methodologies that avoid frustrating the statutory purposes. But the FCC's choice of TELRIC is contrary to the Act and accordingly is unlawful.

CONCLUSION

This Court should affirm that part of the court of appeals' decision vacating the FCC's rule 51.505(b), which required UNE prices to be based on the costs of a hypothetical network "us[ing] the most efficient technology currently available and the lowest cost network configuration."

Respectfully submitted,

R. STEVEN DAVIS
LAWRENCE D. HUSS
SHARON J. DEVINE
ROBERT B. MCKENNA
QWEST COMMUNICATIONS INTERNATIONAL, INC.
1801 California Street
Denver, Colorado 80202
(303) 672-2861

WILLIAM T. LAKE
Counsel of Record
JOHN H. HARWOOD II
SAMIR C. JAIN
RUSSELL P. HANSER
SCOTT A. SHEPARD
WILMER, CUTLER & PICKERING
2445 M Street, N.W.
Washington, D.C. 20037-1420
(202) 663-6000

Counsel for Respondent
Qwest Communications International, Inc.

June 8, 2001

JUN 8 2001

Supreme Court, U.S.
FILED
JUN 8 2001
OFFICE OF THE CLERK

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENT'S BRIEF OF AT&T CORP.

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY AUSTIN BROWN & WOOD
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Respondent

* Counsel of Record

June 8, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

QUESTION PRESENTED

1. Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements?

LIST OF PARTIES AND AFFILIATES

The parties to the proceedings in the Eighth Circuit are listed in Appendix A and Appendix D of AT&T's Petition for Certiorari at 1a and 222a-224a.

Pursuant to Supreme Court Rule 29.6, respondent states as follows: AT&T provides telecommunications, cable, and other services. AT&T has no parent company. No publicly held company owns more than 10 percent of AT&T's stock.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
LIST OF PARTIES AND AFFILIATES	ii
TABLE OF AUTHORITIES	v
STATEMENT OF THE CASE	1
SUMMARY OF ARGUMENT	13
ARGUMENT	17
I. SECTION 252(d)(1)(A) DOES NOT REQUIRE A HISTORICAL-COST RATEMAKING METHOD	17
II. THE TAKINGS CLAUSE DOES NOT REQUIRE THE 1996 ACT TO BE INTERPRETED TO MANDATE HISTORICAL-COST RATEMAKING	24
A. Even If TELRIC Required That Network Elements And Interconnections Be Provided Below Historical Cost, The LECs Have Presented No Serious Takings Claim	26
B. The Adoption Of TELRIC Would Raise No Substantial Takings Claim Even If The Method Governed The Determination Of All Of The LECs' Regulated Revenues	29
C. The LECs' Claims Of A "Switch" In Methodologies Are Legally Meritless And Depend On Erroneous Extrarecord Assertions	33

TABLE OF CONTENTS – continued

	Page
1. TELRIC Is Not An Impermissible Switch In Methodologies That "Strands" Investment	35
2. The LECs' Regulatory Compact Claim Is Meritless	39
III. THE FCC'S REJECTION OF THE LECS' HISTORICAL-COST PROPOSALS WAS NOT ARBITRARY AND CAPRICIOUS	41
A. All Ratemaking Methods Are Hypothetical And There Is No Basis For The Claim That Other Methods Would Fulfill The Act's Objectives At Lower Administrative And Other Costs	43
B. Competitive Pricing Of Network Elements Does Not Frustrate The Act's Purposes	48
CONCLUSION	50

TABLE OF AUTHORITIES

CASES

	Page
AT&T Corp. v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999)	15, 24, 48
American Commercial Lines, Inc. v. *Louisville & Nashville R.R.*, 392 U.S. 571 (1968)	41
American Paper Inst., Inc. v. *American Elec. Power Serv. Corp.*, 461 U.S. 402 (1983)	41
B&O R.R. v. *United States*, 345 U.S. 146 (1953)	15, 26
Bell Atl. Tel. Cos. v. *FCC*, 79 F.3d 1195 (D.C. Cir. 1996)	5
Brooks-Scanlon Co. v. *Railroad Comm'n*, 251 U.S. 396 (1920)	28
Chevron, U.S.A., Inc. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984)	17
Consumers' Counsel v. *FERC*, 914 F.2d 290 (D.C. Cir. 1990)	44
Duquense Light Co. v. *Barasch*, 488 U.S. 299 (1989)	*passim*
Entergy Gulf States, Inc. v. *Louisiana PSC*, 726 So. 2d 870 (La. 1999)	44
FERC v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979)	31
FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944)	3, 20, 22, 31
FPC v. *Texaco, Inc.*, 417 U.S. 380 (1974)	15, 28
Kansas Gas & Elec. Co. v. *State Corp. Comm'n*, 720 P.2d 1063 (Kan. 1986), *vacated in part*, 481 U.S. 1044 (1987)	44
Keystone Bituminous Coal Ass'n v. *DeBenedictis*, 480 U.S. 470 (1987)	41
Long Island Lighting Co. v. *PSC*, 523 N.Y.S.2d 615 (N.Y. App. Div. 1987)	44
Louisville Bridge Co. v. *United States*, 242 U.S. 409 (1917)	41

TABLE OF AUTHORITIES – continued

	Page
Market St. Ry. v. *Railroad Comm'n*, 324 U.S. 548 (1945)	31
Mobil Oil Exploration & Producing S.E., Inc. v. *United Distribution Cos.*, 498 U.S. 211 (1991)	21, 32, 40
Munn v. *Illinois*, 94 U.S. 113 (1876)	39
National Ass'n of Greeting Card Publishers v. *United States Postal Serv.*, 462 U.S. 810 (1983)	14, 18, 19
Nebbia v. *New York*, 291 U.S. 502 (1934)	39
New Orleans v. *FERC*, 67 F.3d 947 (D.C. Cir. 1995)	43
Olson v. *United States*, 292 U.S. 246 (1934)	30
Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	28, 40
Reno v. *Flores*, 507 U.S. 292 (1993)	25
Smyth v. *Ames*, 169 U.S. 466 (1898), *overruled by FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942)	3, 30, 31
TWA, Inc. v. *CAB*, 385 F.2d 648 (D.C. Cir. 1967)	44
Tennessee Elec. Power Co. v. *TVA*, 306 U.S. 118 (1939)	40
United States ex rel. TVA v. *Powelson*, 319 U.S. 266 (1943)	30
United States v. *Miller*, 317 U.S. 369 (1943)	30
United States v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985)	15, 25, 28, 33
United States v. *Security Indus. Bank*, 459 U.S. 70 (1982)	25
United States v. *Winstar Corp.*, 518 U.S. 839 (1996)	41
Wisconsin v. *FPC*, 373 U.S. 294 (1963)	20

TABLE OF AUTHORITIES – continued

CONSTITUTION AND STATUTES

	Page
U.S. Const. amend. V	30
47 U.S.C. § 213	14, 18
§ 251	17, 23
§ 252	*passim*
220 Ill. Comp. Stat. 5/13-502(c)	46
Mich. Comp. Laws Ann. § 484.2208(9)	46
Minn. Stat. Ann. § 237.59	46
§ 237.772	46
Tex. Util. Code Ann. § 58.055(c)	46
Utah Code Ann. § 54-8b-3.3(5)	46
Wy. Stat. Ann. § 37-15-402(a)	46

ADMINISTRATIVE DECISIONS

Application by Bell Atl. New York for Authorization Under Section 271 of the Communications Act, 15 FCC Rcd. 3953 (1999), *aff'd*, 220 F.3d 607 (D.C. Cir. 2000)	9
Connecticut Light & Power Co., 43 F.E.R.C. ¶ 63,029 (1984)	44
Continuing Prop. Records Audit, 14 FCC Rcd. 7019 (1999)	6, 38
Federal-State Joint Bd. on Universal Serv., 14 FCC Rcd. 20156 (1999)	24, 47
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, 9 FCC Rcd. 4527 (1994)	46
Joint Application by SBC Communications Inc., S.W. Bell Tel. Co. for Provision of In-Region InterLATA Servs. in Kan. & Okla., No. 00-217, 2001 WL 55637 (F.C.C. Jan. 22, 2001)	9
Rates for Dominant Carriers, 4 FCC Rcd. 2873 (1989)	4, 5

TABLE OF AUTHORITIES – continued

	Page
Rates for Dominant Carriers, 5 FCC Rcd. 6786 (1990)	4, 6
Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exchange Carriers, 5 FCC Rcd. 7507 (1990)	5
Separation of Costs of Regulated Tel. Serv. From Costs of Nonregulated Activities, 2 FCC Rcd. 1298 (1987)	4
SCHOLARLY AUTHORITIES	
W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Service To Rivals*, 73 N.Y.U. L. Rev. 1122 (1998)	36
S. Breyer, *Regulation and Its Reform* (1982)	21
C. Horngren et al., *Cost Accounting: A Managerial Emphasis* (10th ed. 2000)	18
H. Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999)	36, 39, 40
1 A. Kahn, *The Economics of Regulation* (1988)	3
A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191 (1987)	18, 42
C. Phillips, Jr., *The Regulation of Public Utilities* (1993)	21
J. Rossi, *The Irony of Deregulatory Takings*, 77 Tex. L. Rev. 297 (1998)	41
R. Seavoy, *The Origins Of The American Business Corporation, 1784-1855* (1982)	39
OTHER AUTHORITIES	
BellSouth Corp. 10-K (filed Mar. 2, 2001)	12
Black's Law Dictionary (7th ed. 1999)	14, 18

TABLE OF AUTHORITIES – continued

	Page
FBN Telecom Year In Review – 2, Federal Filings Newswire, Jan. 2, 2001	12
Qwest Communications Int'l Inc. 10-K (filed Mar. 16, 2001)	12
SBC Communications Inc. 10-K (filed Mar. 12, 2001)	12
Verizon Communications Inc. 10-K405 (filed Mar. 23, 2001)	12
M. Farrell, *ICG Tanks, Depressing Other CLECs*, Multichannel News, Oct. 2, 2000	12
R. Farzad, *Has the Telecom War Been Won?*, Dow Jones News Service, May 15, 2001	12
Federal Communications Comm'n, *Interstate Rate of Return Summary, available at* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/ IAD/ror00.pdf	29
Federal Communications Comm'n, *1999 Statistics of Communications Common Carriers* (Aug. 11, 2000)	9
Federal Communications Comm'n, *Trends in Telephone Service* (2000), *available in* Press Release, Federal Communication Comm'n, FCC Releases Study on Telephone Trends (Dec. 21, 2000)	29
Press Release, Federal Communications Comm'n, FCC Releases Latest Data on Local Telephone Competition (May 21, 2000)	35
R. Fisher, *From the Desk of . . . Robert Fisher*, Comm. Today, Dec. 22, 2000	12
R. Krause, *Verizon's New York Fight Key to AT&T Challenge*, Investors' Bus. Daily, Aug. 15, 2000	11
S. Levine et al., *2001: We Make Eight Predictions for the Year in Telecom*, America's Network, Jan. 1, 2001	12

TABLE OF AUTHORITIES – continued

	Page
J. Mulqueen, *ICG Hit Hard by Revenue Shortfall, Resignations*, Interactive Week, Oct. 8, 2000.....	12
S. Schiesel, *For Most Local Phone Users, Choice Is Not Yet an Option*, N.Y. Times, Nov. 21, 2000.....	13
S. Schiesel, *Sitting Pretty: How Baby Bells May Conquer Their World*, N.Y. Times, Apr. 22, 2001.....	12
P. Sherer, *Deals & Deal Makers: Too Much Telecom*, Wall Street J., Aug. 15, 2000.....	12
J. St. Onge, *A Bankruptcy Boom Is Starting To Have Ripple Effects*, Dow Jones News Service, Oct. 5, 2000.....	12

STATEMENT OF THE CASE

AT&T's Petitioner's Brief demonstrated that the Eighth Circuit erred by vacating the FCC's TELRIC regulation insofar as it requires that interconnection and network element rates be based on the costs of efficiently replacing the relevant facilities of the incumbent local exchange carrier ("LEC"). This holding, among other errors, is inconsistent with the Eighth Circuit's correct conclusion that the terms and "stated purposes" of the Telecommunications Act of 1996 are best promoted by a forward-looking incremental cost method. The Eighth Circuit's holding would require either a forward-looking method that is less favorable to LECs than TELRIC or the reproduction cost method that long has been uniformly condemned as irrational and as the worst of all possibilities.

Because the Eighth Circuit's holding is so plainly untenable, the incumbent LECs separately petitioned for review and claimed that the Eighth Circuit was wrong in upholding the use of any forward-looking cost method. They contend that it is plain from the Act's terms and from the context in which it was enacted that Congress required interconnection and network element rates to be based on the "historical costs" that are recorded in the LECs' books. They further claim that any other construction of the Act would present serious issues under the Takings Clause and that the FCC's rejection of historical cost was arbitrary and capricious.

As explained in detail below, these contentions are baseless. They are squarely foreclosed by the Act's terms. Moreover, they rest on the notion that the FCC was required to repudiate the economic and regulatory principles that provided the background for the 1996 Act. At that time, the FCC (and virtually all states) had determined that historical-cost ratemaking could not foster efficiency and had abandoned it even for the purpose of setting the LECs'

maximum earnings and revenues from their overall regulated services. Still more pertinently, the FCC and states had held that historical costs were irrelevant to competitive markets, and where competition had been authorized with other LEC services, they had required that LECs provide access to the essential facilities that they control under forward-looking cost standards. The LECs' Brief does not even acknowledge these facts. Instead, it attempts to divert the Court's attention from them by making a series of extrarecord assertions about the effects of the FCC's TELRIC rules that are out of order, unsupported by any competent evidence or findings, and demonstrably false.

AT&T's Petitioner's Brief provided a full statement of background to the FCC's adoption of TELRIC. But to place the LECs' claims in context requires some additional discussion.

1. In the past, the FCC and individual states would periodically conduct "rate cases" to determine the overall revenue requirements and earnings that incumbent LECs would be allowed in the respective interstate or intrastate jurisdictions. These determinations were based on estimates of the LECs' overall "costs of service." While there are different cost of service methods, each uses a formula in which total annual revenues were to be the sum of the LECs' (1) reasonable operating expenses, (2) depreciation (that is, the loss in value of investment in the LECs' plant during the year), and (3) a reasonable return on the LECs' net investment (sometimes called the "rate base"). The second and third prongs of this formula required a determination of the value of the LECs' total investment.

While regulatory authorities would regulate a utility's overall revenues and earnings under these standards, they generally did not make cost of service determinations for individual services during the time in which LECs had monopolies over all the telecommunications services and equipment used in their franchised territories. Rather, the

overall revenue requirements were allocated among individual services to promote various social objectives and to reflect the "value of service." Charges for basic residential local service were set at relatively low levels and charges for residential long distance service, business services, and other services were set at higher levels.

2. To determine the depreciation and return on investment components of revenue requirements, regulators must first determine the value of the LECs' overall investment. Prior to 1944, this determination was made under a "fair value" method in which regulatory bodies were required to consider a host of factors such as the original cost of the property, the cost of replacing the functions that make it valuable, and the cost of reproducing the precise equipment that the LEC was then using. *Smyth* v. *Ames*, 169 U.S. 466, 547 (1898). To implement "fair value" ratemaking, courts increasingly required determinations of the costs of reproducing the LECs' existing facilities "brick by brick." 1 A. Kahn, *The Economics of Regulation* 37-38, 112-13 (1988).

In 1944, this Court held that fair value ratemaking is no longer constitutionally required. *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602-05 (1944). The FCC and most states then generally began to set rates under a method that is variously referred to as "original cost," "historical cost," "embedded cost" or "prudent investment." Under this method, the current value of the LECs' investment is the amount of the historical book investments of the LEC, minus investments that were found imprudent at the time they were made, minus prudent investments that were found not to be currently "used and useful" in the provision of the regulated service, and minus accumulated depreciation.

3. Beginning in the 1980s, the FCC and virtually all state commissions determined that it was not in the public interest to continue to attempt to regulate the overall revenues and earnings of LECs under such "backward-looking" historical prudent-investment methods. They determined that this

method could not be administered in ways that would foster efficiency and prevent LECs from earning excessive monopoly profits.

For example, the FCC determined that historical-cost regulation gave LECs no "incentive . . . to control expenses" and that, under many conditions, it actually created positive incentives for them to "gold plate" their networks, to install capacity far in excess of that currently required to provide regulated services, and otherwise "to adopt inefficient, capital intensive approaches to business operations." *Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6790 (¶ 29 n.30) (1990). The reason was that, absent determinations of imprudence, the LECs' regulated rates would allow them to recover and earn a full economic return on whatever amounts were invested. *Id.* ¶ 29 & n.30 (citing authorities). Further, to the extent that excess capacity was installed to allow LECs to provide future regulated or unregulated services that face competition, today's monopoly ratepayers would subsidize the LECs' future competitive operations. *Separation of Costs of Regulated Tel. Serv. From Costs of Nonregulated Activities*, 2 FCC Rcd. 1298, 1301 (¶ 16) (1987).

And the FCC found that regulatory bodies could not "administer" a prudent-investment methodology in ways that would either "counteract these incentives" or otherwise foster efficiency, for a number of independent reasons. *Rates for Dominant Carriers*, 4 FCC Rcd. 2873, 2890 (¶ 31) (1989). First, it stated that regulators could never be assured of "obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs." *Id.* Second, it concluded that even if it obtained accurate historical-cost information, it did not have the "the resources to review in detail the thousands of individual business judgments a carrier makes before" making any investment. *Id.* at 2890 (¶ 31). Third, the FCC found that even if there were the "vast increase[s] in [its] resources . . . required" to conduct these after-the-fact retrospective reviews, it "could not hope to

secure the kind of information that would permit [it] to second-guess a carrier's managers." *Id.* at 2909 (¶ 78). Finally, the FCC concluded that even "if [it] were to try to make these type of judgments, it would be very difficult to enforce them." *Id.*

The FCC and virtually all states thus decided to abandon historical cost of service regulation. Instead, they adopted "price caps" or other forms of "incentive" regulation that partially sever the link between a LEC's costs and its earnings. These systems make no judgment that LECs' existing rates reflect the efficient costs of service. Rather, they seek to assure only that future regulation does not introduce any greater inefficiencies. They thus "cap" a LEC's existing prices at their current levels, and require future annual reductions in the overall rates by percentages that are intended to represent the LEC's expected attainable increases in productivity, adjusted for inflation. Conversely, future increases are permitted if the rate of inflation exceeds the presumed percentage increase in the LEC's productivity.

Price cap regulations take away the LECs' prior right to recover all their historical prudent investment. In particular, under the FCC's price cap rules, a LEC will not recover the FCC's authorized rate-of-return (11.25%[1]) on its prudent historical investment if it fails to achieve the presumed levels of efficiency and productivity. But price cap regulations do not completely sever the link between a LEC's book "costs" and prices. The FCC regulations continue to require LECs to account for costs and to calculate rates of return, and these calculated rates of return can have consequences for the LECs' earnings. For example, until recently, FCC regulations required LECs to "share" with ratepayers returns above certain levels. See *Bell Atl. Tel. Cos.* v. *FCC*, 79 F.3d 1195, 1199 (D.C. Cir. 1996). In addition, if calculated rates of

---

[1] *Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exchange Carriers*, 5 FCC Rcd. 7507 (1990).

return fall below certain levels (today 10.25%), LECs are entitled to rate increases. *Rates for Dominant Carriers*, 5 FCC Rcd. at 6802 (¶ 127). Most fundamentally, the FCC periodically reexamines its regulations or resets the productivity offsets, and the calculated rates of return are used in these proceedings.

For these reasons, while price caps do not guarantee recovery of prudent investment, they also do not eliminate LECs' incentives to include inappropriate investments in their ratemaking books.[2] Indeed, it recently came to light that these books contain many entries for equipment that either was never installed or has been discarded. See *Continuing Prop. Records Audit*, 14 FCC Rcd. 7019, 7019 (¶ 1) (1999).

4. At the same time, while regulatory authorities abandoned direct regulation of the overall regulated earnings of LECs, they continued to exercise jurisdiction to determine appropriate prices of individual LEC services or products. This was necessary because competition had been authorized with a number of LEC retail services in the intervening years, and while LEC competitors could themselves provide some of the components of these services, they had to obtain other essential inputs from the incumbent LECs. The LECs' control over these essential inputs gave them the ability to prevent competition through one of two related methods that effect price-cost squeezes and give the LECs the ability to charge prices that their competitors cannot match. First, the LECs could misallocate the costs of competitive retail services to their monopoly operations, recover them from captive ratepayers, and thereby use monopoly revenues to

[2] Both AT&T's and the LECs' economic experts have acknowledged this point. *See, e.g.*, AT&T's Opposition to the Four RBOCs' Motion to Vacate the Decree, William Baumol Aff. at 31, *United States* v. *Western Elec. Co.*, No. 82-0192 (D.D.C. filed Dec. 7, 1994); Motion of Bell Atlantic Corp., BellSouth Corp., NYNEX Corp., and Southwestern Bell Corp. to Vacate the Decree, David Sappington Aff. at 11, *United States* v. *Western Elec. Co.*, No. 82-0192 (D.D.C. filed July 6, 1994).

subsidize below-cost retail prices that their competitors could not match. Second, the LECs could charge their competitors prices for access to their essential facilities that exceed the economic costs which the LECs incur when they use those same facilities to provide competing services.

To prevent such anticompetitive pricing, states and the FCC almost uniformly held that the LECs' historical "sunk" costs were irrelevant, and they generally regulated the relevant LEC rates under a long run incremental cost method that is called "Total Service Long Run Incremental Cost" or "TSLRIC." See AT&T Pet'rs' Br. 6-12. It is based on the full economic cost of replacing the LECs' facilities with the most efficient generally available alternatives.

5. To foster local competition, the 1996 Act requires that LECs provide competitors with interconnections and access to network element at rates that are based on the "cost" of "providing" them. In the FCC rulemaking proceeding, the LECs' economic experts acknowledged that the efficiency objectives of the Act would be best met by basing these rates on long run incremental cost and by allowing LECs to recover investments in any currently underdepreciated assets either through rates for other services or through explicit subsidy payments.[3] Further, the record evidence demonstrated in detail that, in addition to the other factors that made use of historical cost inappropriate, the method would be difficult to administer in ways that would insure that LECs and their competitors incurred the same costs in using essential LEC facilities. See, *e.g.*, AT&T Reply Comments (May 30, 1996), W. Baumol et al. Reply Aff. at 5-7 & n.5 (JA 146-48).

[3] *See* Bell Atlantic Comments (May 16, 1996), Robert Crandall Decl. at 6 (JA 84-85); *see also id.*, Jerry Hausman Aff. at 2-3 (JA 89-92); GTE Comments (May 16, 1996), Edward Beauvis Aff. at 2-4, (JA 103-07); US WEST Comments (May 16, 1996), Robert Harris and Dennis Yao Report at 5 (JA 136-38); Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 8 (JA 160-62).

As economic experts explained to the FCC, under a historical-cost method LECs would have the incentive and the ability to misallocate retailing and other costs to network elements, to artificially raise their competitors' costs, and to require their competitors' customers to pay twice for retail functions and for facilities that the competitors were themselves providing. A historical-cost method would further require tribunals to attempt to allocate statewide costs among areas having different population densities and to exclude the cost of facilities not needed to meet existing demand for regulated telecommunications services. The experts explained that all of these problems would be avoided by a "bottoms up" TSLRIC method that determined the costs that are today required to be incurred to install and operate properly sized facilities. See, *e.g.*, AT&T Comments (May 16, 1996), W. Baumol et al. Aff. at 3-13 (JA 60-73); W. Baumol et al. Reply Aff. at 1-7 & n.5 (JA 140-48).

The FCC adopted a TSLRIC method to govern the setting of rates for interconnections and network elements. However, the FCC called the method Total Element Long Run Incremental Cost or "TELRIC" because it would primarily be applied to determine the cost of providing network elements, not the cost of services. AT&T Pet'rs' Br. 17-19.

6. The record before the Court contains no evidence of what the LEC interconnection and network element rates would be under either a historical-cost method or TELRIC. The LECs' Petitioners' Brief has nonetheless sought to color the proceedings in this Court by relying on a series of unadjudicated and self-serving extrarecord assertions. LEC Br. 10, 31, 40.

For example, the LECs repeatedly claim that TELRIC produces rates that are "50% below historical cost." *Id.* Their principal contention is that an FCC model shows that the TELRIC of the total national LEC networks is $180 billion, but that the amount that the LECs "actually invested" is $342 billion. *Id.* at 10-11 & nn.6-7.

But the statistics on which the LECs rely provide no support for their claim. Preliminarily, the FCC model in question is used to determine the cost of providing "universal" basic telephone service. It thus does not cost all the facilities that LECs make available as network elements (which include facilities used to offer specialized and advanced telecommunications services), but only the facilities required to provide basic service. The FCC has thus found that universal service cost calculations cannot be presumed to reflect the appropriate level of network element rates under TELRIC.[4]

More fundamentally, the $342 billion to which the LECs refer is derived from a table that tracks their *gross* capital investment.[5] But for purposes of comparison with TELRIC's valuation of LEC networks, the more relevant figure is *net* depreciated historical investment, which reflects the estimated losses in value in their equipment due to the development of lower cost substitutes and to wear and tear. This represents the current value of the LEC networks under an historical-cost ratemaking method. According to the LECs' same statistical source, the incumbent LECs' net investment is about $166 billion.[6] TELRIC thus calculates a significantly higher current value to the LECs network – $180 billion plus the value of facilities excluded from the universal service cost calculations – than does a historical-cost method ($166

---

[4] *Application by Bell Atl. New York for Authorization Under Section 271 of the Communications Act*, 15 FCC Rcd. 3953, 4087 (¶ 245) (1999), *aff'd*, 220 F.3d 607, 619-20 (D.C. Cir. 2000); *Joint Application by SBC Communications Inc., S.W. Bell Tel. Co. for Provision of In-Region InterLATA Servs. in Kan. & Okl.*, No. 00-217, 2001 WL 55637, ¶ 84 (FCC Jan. 22, 2001).

[5] LEC Br. 11 n.6 (citing Federal Communications Comm'n, *1999 Statistics of Communications Common Carriers* tbl. 2.7, at 32 (Aug. 11, 2000)).

[6] Federal Communications Comm'n, *1999 Statistics of Communications Common Carriers* tbl. 2.9, at 50 (Aug. 11, 2000).

billion). While these two figures are not perfectly comparable, they foreclose any claim that TELRIC necessarily produces dramatically lower valuations, much less valuations 50%-60% lower than historical cost.

The only other sources the LECs cite for the claimed 50% difference are assertions in their own affidavits and hearing exhibits. LEC Br. 10 nn.4 & 5, 14 n.10. But those assertions have not been credited or adopted by any court or agency, and they do not remotely establish the proposition the LECs urge upon this Court.[7]

The LECs also contend that TELRIC produces "radically discounted" prices which will inevitably induce massive inefficient entry by competitors, that those competitors will be able to seize substantial market share by targeting and winning business customers that are particularly profitable to serve, and that the LECs will unfairly be left predominantly with residential customers who are falsely asserted to be unprofitable to serve.[8] *Id.* at 5, 13-14. The LECs attempt to

---

[7] For example, the LECs cite their November, 1996 testimony before a state commission for the proposition that "[w]hen state utility commissions began applying TELRIC, they typically produced discounts of 50% below historical cost." LEC Br. 10. That claim is facially false because no state commission had applied TELRIC at that time (three months after TELRIC's adoption), and the testimony merely compared two sets of proposed rates in one state. The LECs also cite LEC testimony in New York for the proposition that the historical monthly cost "for a copper loop" is $33.20 while the TELRIC price "for a loop" is $14.52 (*id.* at 14) – an apple-to-oranges comparison, because the TELRIC price to which they refer was calculated solely for fiber loops, which the New York commission concluded were less costly than copper loops. And the remaining unadjudicated assertions that the LECs cite relate to the separate FCC "'proxy prices'" which were not even derived through TELRIC and which are not before this Court. *Id.* at 10 & n.4; Pet. App. 18a-21a.

[8] As LECs have elsewhere demonstrated, their provision of residential local telephone service generally is profitable for them on a stand-alone basis. That is so even where LECs set retail rates for "basic telephone service" to "residential and rural customers . . . below cost" (LEC Br. 4),

support these claims with citations to a handful of newspaper articles and analyst reports from 1996 and 1997. *Id.* at 13 n.9.

But TELRIC has been in effect for nearly five years,[9] and none of these consequences has remotely occurred. To the contrary, most prices approved by regulators as TELRIC-compliant have proven too high to support competitive entry. In that regard, the Vice-Chairman of the lead Petitioner (Verizon) has publicly stated that local competitors who lease its network elements in New York cannot profitably compete with it at current prices,[10] and AT&T has shown that the same circumstances are likewise present elsewhere in the country.[11]

---

for they more than make up the difference from the access charges they collect from long distance carriers for every call placed or received by a residential customer, from the charges for residential customers' intrastate toll calls, from the charges for "vertical features" like Call Waiting and Caller ID, from the "subscriber line charges" that appear on every customer's bill, and from the explicit universal service subsidy payments that the LECs receive for serving particular residential customers. *See, e.g.*, Direct Testimony of Frank Hatzenbuehler, U S WEST Communications, Inc., *The Investigation and Suspension of Tariff Sheets Filed by U S WEST Communications*, No. 96S-331T (Colo. Pub. Utils. Comm'n Dec. 13, 1996).

[9] Although the Eighth Circuit initially stayed the FCC's rules on jurisdictional grounds, the States announced that they would continue to apply TELRIC anyway. *See* AT&T Pet'rs' Br. 21 & n.23.

[10] He has stated that "leasing [Bell Atlantic's network elements] costs AT&T $22 per residential customer per month," so "'[w]hoever is buying (AT&T's) $24.95 product (its basic local service package) knows they're not making any money on it.'" R. Krause, *Verizon's New York Fight Key to AT&T Challenge*, Investors' Bus. Daily, Aug. 15, 2000, at A6 (quoting Ivan Seidenberg). As he recognized, new entrants incur a host of substantial start-up, operating and marketing costs beyond the cost of leasing network elements, so inflated rates deny competitors the "margins" they need to offer local residential service profitably. *Id.*

[11] *See, e.g.*, Comments of AT&T Corp. in Opposition to SBC Communication Inc.'s Section 271 Joint Application for Kansas and Oklahoma, Michael Lieberman Decl., CC Docket No. 00-217 (Nov. 15, 2000); Reply Comments of AT&T Corp. in Opposition to Verizon New

As a consequence, the more recent newspaper articles and analyst reports state that the competitive LEC industry now stands on the verge of collapse. "[I]nvestors [have] los[t] confidence in the fundamentals of the CLEC business model," M. Farrell, *ICG Tanks, Depressing Other CLECs*, Multichannel News, Oct. 2, 2000, at Finance 48. "[T]here has been 'carnage' among CLEC stocks," J. Mulqueen, *ICG Hit Hard by Revenue Shortfall, Resignations*, Interactive Week, Oct. 8, 2000, and numerous competitive LECs have filed for bankruptcy.[12] At the same time, incumbent LECs continue to add more access lines and their profits are soaring,[13] and "with their seemingly impenetrable local-service fortresses, are emerging as the hands-down winners."[14] These reports thus state that the immediate

---

England Inc.'s Section 271 Application for Massachusetts at 24, CC Docket No. 00-176 (Nov. 2, 2000).

[12] *FBN Telecom Year In Review - 2*, Federal Filings Newswire, Jan. 2, 2001; S. Levine et al., *2001: We Make Eight Predictions for the Year in Telecom*, America's Network, Jan. 1, 2001, at 40; R. Fisher, *From the Desk of . . . Robert Fisher*, Comm. Today, Dec. 22, 2000; P. Sherer, *Deals & Deal Makers: Too Much Telecom*, Wall Street J., Aug. 15, 2000, at C1; J. St. Onge, *A Bankruptcy Boom Is Starting To Have Ripple Effects*, Dow Jones News Service, Oct. 5, 2000.

[13] *See* BellSouth Corp. 10-K, at 34-36 (filed Mar. 2, 2001) (reporting over $500 million growth in local services revenues to over $11 billion and access line growth of approximately 400,000 lines); SBC Communications Inc. 10-K, at 143 (filed Mar. 12, 2001) (reporting local service revenues increasing by 13.2% to over $22 billion and strong access line growth); Qwest Communications Int'l Inc. 10-K, Ex. 13, at F1-F4 (filed Mar. 16, 2001) (reporting increased local voice revenues and addition of over 340,000 access lines); Verizon Communications Inc. 10-K405, at F7-F8 (filed Mar. 23, 2001) (reporting over $700 million growth in local services revenues to over $21 billion driven by increased usage of local network facilities).

[14] R. Farzad, *Has the Telecom War Been Won?*, Dow Jones News Service, May 15, 2001; S. Schiesel, *Sitting Pretty: How Baby Bells May Conquer Their World*, N.Y. Times, Apr. 22, 2001, at Money & Business 1.

"'prospects for local competition look abysmal'" because "'[i]n most of the country, it is just not happening.'"[15]

In short, to say the least, the Court should not assume the truth of the LECs' extrarecord assertion that TELRIC produces rates that have caused significant competitive losses for the LECs and that will leave them serving predominantly "below-cost" customers. And the LECs' tactics underscore the wisdom of this Court's refraining from constitutional judgments regarding claims of confiscation until it has before it real numbers that have been subject to the adversarial process and scrutinized by regulatory agencies and the lower courts.

SUMMARY OF ARGUMENT

There is no merit to the LECs' claim that the FCC acted unlawfully by refusing to require use of historical-cost methods to set rates for interconnection and network elements. The LECs' statutory claims are foreclosed by the Act's terms, its context, and its purposes – all of which demonstrate that, if anything, Congress intended to prohibit the use of historical-cost ratemaking. And there is no substance to the LECs' claim that the statute has to be construed to require a historical-cost method to prevent takings or that it was arbitrary and capricious for the FCC to reject this method.

1. By requiring that rates be based on "cost," 47 U.S.C. § 252(d)(1)(A), Congress did not mandate that interconnection and network element rates be set based on the historical costs recorded in the LECs' ratemaking books. Even when the term "cost" is used in isolation, the LECs' dictionaries and this Court's decisions establish that the term

---

[15] *See* S. Schiesel, *For Most Local Phone Users, Choice Is Not Yet an Option*, N.Y. Times, Nov. 21, 2000, at C1 (quoting B. Adamik, President, The Yankee Group).

can mean either original cost or efficient replacement cost. *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 831-32 (1983); *Black's Law Dictionary* 349 (7th ed. 1999).

Here, the textual context squarely forecloses the LECs' claim that "cost" must (or even can) mean the amount that was originally expended for an element, recorded in the LECs' ratemaking books, and purportedly determined to be prudent in prior rate-of-return ratemaking proceedings. Section 252(d)(1)(A)(i) requires that the rates be "based on the cost (determined *without reference* to a rate-of-return or other rate-based proceeding) of *providing* the interconnection or network element." 47 U.S.C. § 252(d)(1)(A)(i) (emphases added). The LECs' are seeking to rewrite the statute so that it requires that rates be based on the "cost [determined *with reference* to a rate-of-return or other rate-based proceeding] of *purchasing* the element". This claim is peculiarly spurious, for when the Communications Act requires determinations based on "original cost," it says so expressly. *Id.* § 213.

The LECs are also wrong in claiming that original cost ratemaking is required by the historical "context" of the 1996 Act. Congress enacted the 1996 Act long after the FCC and many state commissions had abandoned historical-cost ratemaking on the ground that it fostered inefficiency and could not be administered to prevent LECs from earning excessive profits from their overall regulated operations. More pertinently, it was then black letter law that historical costs are irrelevant to competitive markets, and the FCC and states had long used TSLRIC and other forward-looking methods where, as here, the question was the rates that LECs should be permitted to charge competitors for access to essential facilities.

Further, the Act requires not only that network element rates be based on cost, 47 U.S.C. § 252(d)(1)(A)(i), but also that they be "nondiscriminatory," *id.* § 252(d)(1)(A)(ii). The FCC's unchallenged findings establish that TELRIC

represents the costs that LECs incur in using the elements and that to base rates on historical cost would violate the ban on discrimination. In all events, even if the Act does not require forward-looking methods, it at least gives the FCC "broad methodological leeway" to determine interconnection and network element rates under forward-looking methods. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 423 (1999) (Breyer, J., concurring in part and dissenting in part).

2. The LECs alternatively claim that § 252(d)(1) must be construed to require historical-cost ratemaking to avoid "serious" issues under the Takings Clause. In their view, the rejection of historical cost and the adoption of a forward-looking method raises "substantial arguments" that an uncompensated taking will "necessarily" result. *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 n.5 (1985). This contention is baseless.

First, the adoption of TELRIC could not itself present a risk of a taking even if it were certain that LECs will hereafter be able to prove that network element rates have denied them recovery of historical costs that they have a right to recover. The Order provides that LECs may then petition the FCC for the right to recover the shortfall in other rates that are within the FCC's jurisdiction. This remedy bars any claim that the adoption of TELRIC will necessarily result in a taking. *Id.*; *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 391-92 (1978); *B&O R.R.* v. *United States*, 345 U.S. 146, 148 (1953).

Second, under this Court's holdings, a ratemaking body's decision to adopt historical cost, replacement cost, or some hybrid method to value a utility's investment itself raises no constitutional issue under the Takings Clause. See *Duquense Light Co.* v. *Barasch*, 488 U.S. 299, 310 (1989). There cannot be a substantial takings issue until a rate order is entered whose "total effect" could be said to deny the utility the opportunity to earn a return on investment that reflects the risks of operating under the agency's ratemaking methodology. *Id.* Here, moreover, TELRIC expressly requires that

LECs receive a full risk-adjusted return, so it facially mandates precisely what the Takings Clause requires.

The LECs also rely on the Court's statement that it would raise "serious constitutional questions" if agencies were "to arbitrarily switch back and forth between [ratemaking] methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Id.* at 315. But TELRIC does not represent even a one-time "switch" in ratemaking methodologies, much less an arbitrary switching back and forth that could have such consequences. The TELRIC regulation has no effect on the ratemaking methods that apply to the LECs' interstate and intrastate telephone services. It governs only the new wholesale arrangements that the 1996 Act requires LECs to provide for the first time in order to foster competition. Moreover, by adopting a forward-looking method for this purpose, the FCC followed its own prior decisions.

3. The FCC's rejection of historical-cost ratemaking was not arbitrary and capricious. The FCC had previously found historical-cost ratemaking could not promote efficiency in regulating the LECs' regulated businesses as a whole, much less prevent the LECs from misusing their control over monopoly facilities to impede competition with their own local services. More fundamentally, there was abundant evidence before the FCC – which was overwhelmingly supported by the experience and findings of state, federal, and foreign regulatory tribunals and the LECs' own submissions in other fora – that a forward-looking cost method could be more readily and reliably administered to promote the procompetitive objects of the 1996 Act.

ARGUMENT

I. SECTION 252(d)(1)(A) DOES NOT REQUIRE A HISTORICAL-COST RATEMAKING METHOD.

Section 252(d)(1) adopts three requirements that govern the setting of "just and reasonable rates" for interconnections and network elements. 47 U.S.C. § 252(d)(1)(A). First, the rates must be "based on the cost (determined without reference to a rate-of-return or rate-based proceeding) of providing the interconnection or network element." *Id.* § 252(d)(1)(A)(i). Second, they "may include a reasonable profit." *Id.* § 252(d)(1)(B). Third, the rates must be "nondiscriminatory." *Id.* § 252(d)(1)(A)(ii).

In the LECs' view, these terms, the Act's structure, and the historical context in which it was enacted establish that Congress intended to require that interconnection and network element rates be based on the historical costs that are recorded in the LECs' ratemaking books. They claim that "cost" means the "amount paid" for the facility in question (LEC Br. 19), that prior ratemaking orders establish that the LECs' expenditures are prudent (*id.* at 47), and that Congress intended the term "'cost' [to] refer[] to something already established and readily available," *i.e.*, the LECs' "historical cost as documented on [their] books." *Id.* at 22.

There is no basis for these contentions. If anything, the Act forecloses the method the LECs propose. In all events, the FCC's rejection of their proposal was a reasonable interpretation of the Act and is entitled to deference. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-45 (1984).

1. First, there is no substance to the LECs' contention that the plain meaning of the term "cost" is the "entire amount paid" for an asset. LEC Br. 19 (citing *Black's Law Dictionary* 345 (6th ed. 1990)). This dictionary now contains 30 different definitions of "cost," and these include forward-

looking replacement cost: that is, "[t]he cost of acquiring an asset that is as equally useful or productive as an asset currently held." *Black's Law Dictionary* 349-50 (7th ed. 1999). This Court has thus held that "cost" is a term that has "no technical meaning," that "connotes the use of judgment," and that it permits both historical and forward-looking approaches. *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983).

These principles have special force in the context of the Communications Act in general and of § 252(d)(1) in particular. Where Congress wished to permit or require the use of "original" or historical cost for a regulatory purpose under the Communications Act, it said so expressly. See 47 U.S.C. § 213(b)-(d). Moreover, in § 252(d)(1), the term "cost" is used in a context which manifestly does not compel – and, if anything, forecloses – the LECs' proposed construction.

The LECs' claim is that § 252(d)(1) requires that rates be based on the "historical cost" of purchasing the facilities that comprise the network element or interconnection in question. But that is not what § 252(d)(1) says. It requires that rates be based on the "cost" of "providing" the facility. The cost of "providing" an interconnection or network element is manifestly not what was paid for the relevant facilities in the past, for that amount is "sunk" and unavoidable.[16]

2. The LECs also claim that § 252(d)(1) has to be construed to require a historical-cost method because that was

---

[16] *See* AT&T Pet'rs' Br. 21-37; *see also* A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987); C. Horngren et al., *Cost Accounting: A Managerial Emphasis* 378, 396 (10th ed. 2000) (defining "relevant costs" as "those *expected future costs* . . . that differ among the alternative courses of action being considered," and "especially emphasiz[ing] the idea that all past costs and, in particular, book value (original cost minus accumulated appreciation) of the existing equipment, are irrelevant" (second emphasis omitted)).

the prevailing method of determining costs of service and of setting "just and reasonable" rates at the time the 1996 Act was passed. This claim is wrong, both legally and factually. First, this Court has held that when Congress uses the term "cost" without further specification, it has authorized the ratemaking agency to reject "'fully allocated'" costs or other historical-cost methods, even if they had represented the ratemaking and "accounting methods current at the time the bill was enacted." *National Ass'n of Greeting Card Publishers*, 462 U.S. at 817 & n.3, 831.

Second, the LECs' claim rests on a false factual premise. Historical cost was not the current method when the 1996 Act was passed. To the contrary, the FCC and most states had by then abandoned historical-cost ratemaking even for the purpose of regulating the LECs' overall revenues and earnings. The FCC found that this method gave the LECs incentives to be inefficient and that regulators simply could not administer this ratemaking method in ways that would prevent excessive rates. See *supra* pp. 3-6. Beyond that, even when historical-cost ratemaking had been previously used to establish maximum overall revenues and earnings, the FCC and states had rejected this ratemaking method where, as here, the issue is the individual rates that LECs should charge their competitors for access to essential facilities. These rates had long been set under TSLRIC and other forward-looking replacement cost methods. AT&T Pet'rs' Br. 6-12.

Congress was fully aware of the adverse effects of historical-cost ratemaking. Both the House and Senate had passed bills banning the use of such rate-of-return regulation to establish LECs' maximum earnings. See Order, ¶ 704 (JA 397-98). Although these prohibitions were deleted by the Conference Committee from the 1996 Act, it is preposterous to claim that Congress intended simultaneously to require that network-element and interconnection rates be set under this method.

Beyond that, the language that was not deleted from the 1996 Act squarely bars the LECs' claim (LEC Br. 22, 47) that amounts recorded in the LECs' ratemaking books must be deemed to be reasonable estimates of cost. The LECs base this claim on their assertions that prior state and federal ratemaking proceedings established the "prudence" of these costs. But the parenthetical terms of § 252(d)(1)(A)(i) expressly foreclose any such claim. That section mandates that the cost of providing the element be "determined without reference to a rate-of-return or other rate-based proceeding." 47 U.S.C. § 252(d)(1)(A)(i). Thus, although the LECs are correct that one purpose of the Act is to allow interconnection agreements to be adopted swiftly, § 252(d)(1)(A) prohibits tribunals from doing so by treating prior rate-of-return ratemaking proceedings as establishing that "readily available" entries on the LECs' ratemaking books represent the costs of providing a network element or interconnection. Compare LEC Br. 22.[17]

The LECs' claims are also foreclosed by the fact that § 252(d)(1) specifies a method for setting rates that are "just and reasonable." 47 U.S.C. § 252(d)(1). The Court has held that the "just and reasonable" standard authorizes ratemaking tribunals to adopt any ratemaking method that produces permissible end results. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944); *Wisconsin* v. *FPC*, 373 U.S. 294, 309 (1963). In particular, the Court has rejected claims that this standard requires historical-cost methods and has held

[17] The LECs rely (LEC Br. 22) on the FCC's statement that this parenthetical phrase does not "further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the cost of interconnection and unbundled network elements." Order, ¶ 704 (JA 397). But whether or not § 252(d)(1)(A) would bar prudent-investment ratemaking and the consideration of certain costs, it bars any claim that prior ratemaking proceedings establish that entries on LEC books represent actual costs of providing network elements.

that it authorizes forward-looking replacement cost methods. *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224-25 (1991).

3. The LECs also erroneously claim that there are other provisions of the Act that establish that § 252(d)(1)(A) requires the use of historical-cost ratemaking and prohibits forward-looking methods. Their principal contention is based on § 252(d)(1)(B), which provides that network element and interconnection rates "may include a reasonable profit." 47 U.S.C. § 252(d)(1)(B). The LECs contend that unless historical-cost ratemaking is used, the "entire" subsection that addresses "profit" would be "irrelevant." LEC Br. 20-21. This claim is nonsense. There simply is no relevant difference between historical-cost and forward-looking methods for purposes of affording a "profit" to a regulated utility.

Under both historical and forward-looking cost methods, the utility is to receive revenues that recover the sum of its (1) reasonable operating expenses and taxes; (2) the allowed depreciation on its investment; and (3) a prescribed rate-of-return multiplied by the current value of the utility's investment. See generally S. Breyer, *Regulation and Its Reform* 36-37, 40-41 (1982). Under both methods, the object of the rate-of-return on investment component is to allow the utility to earn a "reasonable profit" – that is, to earn revenues in excess of reasonable expenditures – and to pay dividends to the utility's shareholders. *Id.*[18] Under both methods, the profit is to reflect the risk of operating under the regulatory regime. See *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 310, 315 (1989).

[18] The "return on investment" component is generally comprised of two elements: the cost of servicing the utility's debt (*i.e.*, paying interest on bonds) and return on equity (*i.e.*, the earning and profits from which dividends are paid). S. Breyer, *Regulation and Its Reform* 40-41 (1982); C. Phillips, Jr., *The Regulation of Public Utilities* 388 (1993).

For present purposes, the only difference between historical-cost and forward-looking methods is the way in which they calculate the magnitude of the "reasonable profit" that the regulated firm will be allowed to earn. Historical-cost methods value the investment to which the rate-of-return is applied based on the original cost of the plant, less amounts found to be imprudent and less depreciation. By contrast, TELRIC values the investment based on the current efficient costs of establishing facilities that provide the same functions as the LEC network. Each method can arrive at a value of the LECs' gross investment that is less than the LECs' "actual" past expenditures. Each can thus also be conceived of as having "written off" some fraction of that investment – just as LECs and other corporations routinely write off some of their investments for financial accounting purposes and report earnings and profits to shareholders on this basis in SEC and other filings. See AT&T Pet'rs' Br. 4.

The basis for the LECs' current claim is that the return on investment component of the rate formula is referred to in the FCC's Order (as it is in many contexts) as representing the "cost of capital" – that is, the earnings that a utility must receive to be able to attract debt and equity capital investments. Return on investment can thus be conceived of as a cost of providing a network element or interconnection within the meaning of § 252(d)(1)(A) – such that no separate determination is required under § 252(d)(1)(B). LEC Br. 21. But the use of the term "cost of capital" is equally apt under a historical-cost method. See *Hope Natural Gas Co.*, 320 U.S. at 603. So notions of "profit" can be "embodied" in a "definition of cost" under historical-cost methods as well. LEC Br. 21. Thus, if the LECs' claim were valid, the Act would foreclose both historical-cost and forward-looking methods. But the claim is clearly not valid. Whether a ratemaking body uses the term "return on investment" or

"cost of capital," it is exercising discretion to allow the LEC an opportunity to earn a "reasonable profit."[19]

4. Finally, the LECs' claims are barred by an independent requirement of § 252(d)(1)(A) that they simply ignore. The Act mandates not only that network element and interconnection rates be based on costs, 47 U.S.C. § 252(d)(1)(A)(i), but also that the rates be "nondiscriminatory." *Id.* § 252(d)(1)(A)(ii); *accord id.* § 251(c)(2), (3). Congress adopted this separate requirement to make it explicit that LECs cannot provide interconnections and network elements to competitors at economic costs that are higher than the LECs themselves incur when they use the same facilities to provide their own competing services. Order, ¶¶ 217-218, 859-862 (JA 277-78, 434-36). The LECs cannot and do not challenge the FCC's finding that TELRIC represents the economic costs that LECs incur when they use network elements in their retail services and that it would be discriminatory if LECs could impose higher costs on competitors. *Id.* Thus, § 252(d)(1)(A)(ii) independently forecloses the LECs' claim that they have a statutory right to base network element rates on historical costs whenever historical costs are higher than rates set under TELRIC.

For all the foregoing reasons, the Act should, if anything, be held to foreclose historical-cost ratemaking. But to reject the LECs' interpretive claims, the Court need only hold that the "general terms" of § 252(d)(1) convey "broad methodological leeway" and "say little about the 'method

---

[19] The LECs also have made claims (LEC Br. 22-23) based on the separate standard that § 252(d)(2) adopts for setting rates for the "wholesale services for resale" authorized by § 251(c)(4). Because this is a separate statutory provision, it would be besides the point even if it did guarantee the LECs recovery of their "historical costs." But it does not. To the contrary, the provision allows new entrants to obtain services that are offered at retail below their costs and that are subsidized by other services (such as exchange access) and universal service payments under section 254 of the Act. Order, ¶¶ 875, 907-908 (JA 436-37, 437-38).

employed' to determine a particular rate." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 423 (1999) (Breyer, J., concurring in part and dissenting in part).

II. THE TAKINGS CLAUSE DOES NOT REQUIRE THE 1996 ACT TO BE INTERPRETED TO MANDATE HISTORICAL-COST RATEMAKING.

The LECs alternatively argue that the Takings Clause of the Fifth Amendment required the FCC to reject TELRIC and to adopt a method that guarantees that LECs will recover all their historical costs in their rates for network elements and interconnections. The LECs here concede – as they must – that the Eighth Circuit correctly held that they have not shown that the FCC's adoption of a forward-looking method has resulted or will result in an uncompensated taking of their property and that any takings claim is not ripe for review and premature. LEC Br. 37.

However, the LECs contend that they do not have to prove an actual uncompensated taking to invalidate forward-looking pricing. Although § 252(d)(1) does not compel a historical-cost method, they claim that such a method would nonetheless have represented a permissible interpretation of the statutory terms and that historical-cost ratemaking would raise no constitutional issues. By contrast, they contend that the rates that are set under the FCC's forward-looking approach will give rise to "serious constitutional questions" under the Takings Clause and that the FCC was required to adopt an historical-cost interpretation to avoid any constitutional doubts. LEC Br. 37.

The short answer to this claim is that "historical cost" is not a permissible interpretation of § 252(d)(1)(A)(i). Even if "cost" could be construed to mean "historical" cost – which is doubtful – the LECs cannot and have not disputed that including all historical cost in network element and interconnection rates would violate the separate

"nondiscrimination" requirements of § 252(d)(1)(A)(ii) and § 251(c)(2), (3). See *supra* p. 23.

In all events, the LECs' claims are otherwise meritless. "The 'constitutional doubts' argument has been the last refuge of many an interpretive lost cause." *Reno* v. *Flores*, 507 U.S. 292, 314 n.9 (1993). "Statutes should be interpreted to avoid *serious* constitutional doubts, not to eliminate all possible contentions that the statute *might* be unconstitutional." *Id.* (citation omitted). And when agency regulations are challenged on the ground that they may be implemented in ways that could give rise to future takings claims, the acceptance of these interpretative contentions can "merely frustrate[] permissible applications of a statute or regulation." *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 (1985). The Court has thus held that it will not invalidate an agency's implementing regulation unless there is a "substantial argument" that "there is an identifiable class of cases in which application of a statute will necessarily constitute a taking." *Id.* at 128 n.5; see *United States* v. *Security Indus. Bank*, 459 U.S. 70, 75-76 (1982).

The LECs cannot make this showing. Even if the FCC were here regulating the LECs' overall regulated revenues, this Court's holdings establish that historical cost and forward-looking replacement cost are each permissible methodologies, and the FCC's adoption of a forward-looking method is no more likely to produce "end results" that give rise to takings claims than is a historical-cost method. Accordingly, the LECs' claims that TELRIC will necessarily produce unconstitutional results are not based on the terms of the regulation. Rather, they rest on a series of extrarecord factual assertions about the future effects of the regulation that are procedurally improper, factually unsupported, and erroneous.

A. Even If TELRIC Required That Network Elements And Interconnections Be Provided Below Historical Cost, The LECs Have Presented No Serious Takings Claim.

Preliminarily, the adoption of TELRIC would raise no federal constitutional question even if there were substantial claims that TELRIC would result in rates for network elements and interconnections that exclude costs that LECs incur in providing them and that the LECs are entitled to recover. If that were to occur, the FCC has made it clear that the LECs are entitled to seek to recover that shortfall through other FCC-regulated charges. Under this Court's holdings, this remedy precludes any claim that the adoption of TELRIC itself presents a serious risk of an uncompensated taking.

First, contrary to the LECs' suggestions, even if it were certain that TELRIC rates would be below cost, that would not itself establish an uncompensated taking. In *B&O Railroad* v. *United States*, 345 U.S. 146 (1953), the Court dismissed a takings claim that rested only on the allegation that a railroad had been required to ship a particular commodity at a rate below its costs. The Court held that "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities." *Id.* at 150. Similarly, in *Duquesne Light Co.* v. *Barasch*, the Court held that it was irrelevant that the utility had been denied any compensation for its prudent investment in a cancelled plant, for the utility's overall revenue from all its regulated operations was sufficient to allow it to attract capital. 488 U.S. 299, 310-12 (1989).

Second, the FCC's Order provides that in the event network element rates do not cover all the costs that LECs are entitled to recover, they can seek to make up the difference through other FCC-authorized charges. In particular, before the FCC, the LECs had claimed that they are threatened with a future

shortfall because they formerly were required to depreciate their equipment over artificially long periods of time and that they had substantial "depreciation reserve deficiencies" which could not be recovered in network element rates under TELRIC. In actual fact, subsequent events have eliminated any deficiencies, and the FCC recently found that LECs now have substantial depreciation reserve surpluses.[20]

However, the decisive fact for present purposes is that the FCC's TELRIC Order did not hold that the LECs are to be barred from recovering any depreciation reserve or other shortfall. It merely concluded – consistent with the testimony of the LECs' economic experts (see AT&T Pet'rs' Br. 16-17) – that including these amounts in network element and interconnection rates is not the proper remedy for underdepreciated assets, for artificially inflating these charges will distort local competition. Order, ¶ 706 (JA 399-400). The FCC thus provided that after TELRIC is implemented, the LECs will be free to come to the FCC and demonstrate that there was an unrecovered depreciation deficiency or some other shortfall. The FCC would then consider authorizing the recovery of these amounts in universal service surcharges or in other rates within its jurisdiction. *Id.* ¶¶ 706-707 (JA 399-401).[21]

No LEC has attempted to show that it in fact has a shortfall in its rates due to a depreciation reserve deficiency or otherwise. The LECs' claim to this Court rests on the ground that, if a LEC were to make such a showing, the FCC might fail to take the corrective action that would prevent an uncompensated taking of the LEC's property.

---

[20] *Federal-State Joint Bd. on Universal Serv.*, 14 FCC Rcd. 20156, 20345 (¶ 427) (1999).

[21] The LECs complain that it has not yet done so. LEC Br. 11-12, 36 n.15. But whether there are residual unrecovered historical costs can only be determined after state commissions set TELRIC-based rates.

However, under settled law, these facts do not state a substantial claim that the adoption of TELRIC will necessarily result in a taking of LEC property. If an uncompensated taking were to occur, it would be a consequence not of the adoption of TELRIC, but of the FCC's failure to enter an appropriate order in a future proceeding in which the LEC demonstrated a shortfall. This Court has held that where, as here, an agency's regulation rests on a reasonable interpretation of the underlying statute and is otherwise facially valid, it cannot be invalidated based on speculation that the agency would effect an uncompensated taking in a future proceeding. *Riverside Bayview Homes, Inc.*, 474 U.S. at 128.

Even more pertinently, there have been two prior cases in which federal agencies adopted new ratemaking methods and in which the utility's remedy in the event of a claimed shortfall was to seek relief before the agency. In each case, the Court rejected the same claim that the LECs make here: that the new regulatory regime was unlawful because it failed to adopt mechanisms to guarantee utilities the recovery of any shortfall. *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 392-93 (1974); *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-71 (1968).

The LECs have attempted to avoid these holdings by advancing another claim. They contend that, under the Takings Clause, the FCC cannot rely on revenues from other services or explicit subsidy payments to make up for any shortfalls that may result from the LECs' provision of unbundled network elements. In their view, the teaching of *Brooks-Scanlon Co.* v. *Railroad Comm'n*, 251 U.S. 396, 399 (1920), is that in assessing the total effect of the order of a regulatory agency, the inquiry must be limited to the "segment" of the business whose "revenues" the agency "has control over and is responsible for generating." LEC Br. 33, 34 (emphasis omitted). It follows, the LECs claim, that the Takings Clause required the FCC to assure that the LECs'

"UNE business" will "generate a sufficient return to stand on its own." *Id.* at 35.

But UNEs are not the only revenues that the FCC regulates, so this latter claim would be erroneous even if the LECs' reading of *Brooks-Scanlon* were sustainable.[22] The FCC not only has jurisdiction over the pricing standards for network elements, but also over LEC interstate exchange access and other interstate charges that generate over 25% of their $112 billion in annual revenues.[23] Further, the LECs are now earning returns on their interstate investment of between 17.5% and 20.8%.[24] There is no basis for any claim that LEC revenues from interstate services could not make up for any shortfall resulting from the LECs' provision of UNEs at TELRIC-based rates.

B. The Adoption Of TELRIC Would Raise No Substantial Takings Claim Even If The Method Governed The Determination Of All Of The LECs' Regulated Revenues.

The LECs' claim suffers from a far more fundamental defect. Even if TELRIC governed the determination of all of the LECs' regulated revenues, the fact that it does not guarantee a return that formally applies to all the LECs'

---

[22] *Brooks-Scanlon*'s holding is only that an agency cannot require a firm to operate a regulated business (there, a railroad) at a loss and rely on unregulated revenues (there, from lumber yards and sawmills) to make up the difference.

[23] Federal Communication Comm'n, *Trends in Telephone Service*, Tables 16.2 and 16.4 (2000) ($29 billion in access and subscriber line charges), *available in* Press Release, Federal Communication Comm'n, FCC Releases Study on Telephone Trends (Dec. 21, 2000).

[24] The weighted average return of the price-cap carriers (LECs) for 2000 was 19.53%. Federal Communications Comm'n, *Interstate Rate of Return Summary*, *available at* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf.

historical costs and investment presents no issue under the Takings Clause.

The Takings Clause does not afford any firm a right to recover its historical costs. It requires that the government pay "just compensation" when "private property" is dedicated to a public use. U.S. Const. amend. V. It has been settled for a century that just compensation does not equal the "costs" incurred by an owner in acquiring or developing property.

As a general matter, just compensation is determined by the current value of the property measured by its fair market or rental value – ordinarily "what a willing buyer would pay in cash to a willing seller." *United States* v. *Miller*, 317 U.S. 369, 374 (1943). The current fair market value "may be more or less than the owner's investment. He may have acquired the property for less than its worth or he may have paid a speculative and exorbitant price." *Olson* v. *United States*, 292 U.S. 246, 255 (1934). But "the Fifth Amendment allows the owner only the fair market value of his property; it does not guarantee him a return of his investment." *United States ex rel. TVA* v. *Powelson*, 319 U.S. 266, 285 (1943). Just compensation under the Takings Clause is thus forward-looking, not backward looking.

These same rules apply to regulated monopolies. In *Smyth* v. *Ames*, 169 U.S. 466 (1898), the Court rejected a claim that a railroad was entitled to rates that would fully compensate it for its historical investment in property dedicated to public use. *Id.* at 543. It held that this property must be valued – like ordinary property taken for public use – based on the current "fair value" of utility property rather than its historical cost. *Id.* at 546-47. Recognizing that in most circumstances there is no ready market for such property and hence no established fair market value, *Smyth* required courts to determine value by considering a variety of types of evidence – including the "original cost of construction" and the "present" cost of reproducing the plant – and to compute the

depreciation and return on investment components of rates based on this valuation. *Id.* at 547.

In *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court abandoned the rule of *Smyth* v. *Ames* as a constitutional requirement, stating that, strictly speaking, "'fair value' is the end product of the process of rate-making not the starting point." *Id.* at 601. *Hope* thus upheld rates that had been set under a historical-cost method, but expressly declined to adopt prudent investment as a constitutional requirement or to prohibit use of forward-looking replacement cost methods. It stated that a rate order is constitutional if its "end result" is to provide the opportunity for a return on investment "commensurate with returns on investments in other enterprises having corresponding risks." *Id.* at 603. The Court held that the choice of ratemaking methodology itself raises no constitutional issue. *Id.*

Since *Hope* was decided, this Court has repeatedly rejected claims that utilities are entitled to recover their "prudent investments" and that the use of a "fair market value" method is impermissible. In *Market Street Railway* v. *Railroad Commission*, 324 U.S. 548, 564-65, 569 (1945), the Court upheld a rate order that limited the carrier's compensation to the fair market value of its assets, which (due to declining demand) were less than a third of its historical costs and were also less than the estimates of replacement costs. The Court has similarly rejected claims that a regulated firm has a right to have its rates "'base[d] . . . on [its] own [historic] costs.'" *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979).

More recently, in *Duquesne*, the Court upheld a decision of the Pennsylvania Supreme Court which (based on an intervening change in state law) had revised a rate order so that it denied the utility any return on certain investments that had been prudent when made, but that were no longer "used and useful." 488 U.S. at 312 n.7. The Court noted that Pennsylvania had thereby adopted elements of fair value ratemaking, which attempts more closely to "mimic[]" a

competitive market. *Id.* at 308, 315. The Court again rejected the claims that prudent historical investment should be adopted as the constitutionally required ratemaking methodology because, among other things, such a rule would "unnecessarily foreclose alternatives which could benefit both consumers and investors" – such as "a return to some form of the fair value rule just as its practical problems may be diminishing." *Id.* at 316 & n.10.

The Court thus held that a rate order will be confiscatory only if the "rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Id.* at 312. In this regard, the Court noted that the "impact of certain rates can only be evaluated in the context of the system under which they are imposed," for "[t]he risks a utility faces are in large part defined by the rate methodology." *Id.* at 314-15. And it reaffirmed that the method adopted to value the utilities' investment presents no constitutional issue, for errors in valuation "may well be canceled out by countervailing errors or allowances in another part of the rate proceeding": *e.g.* by the authorized rates of return and depreciation. *Id.* at 314; see *id.* at 317 (Scalia, J., concurring) (no substantial takings questions are presented in a case that "challenges techniques rather than consequences"). Since *Duquesne*, this Court has upheld rate orders that used forward-looking replacement cost methods to set "just and reasonable" rates. *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224 (1991).

In short, under this Court's decisions, the adoption of a forward-looking replacement cost method itself raises no constitutional issues under the Taking Clause, and a subsequent rate order is valid so long as it allows returns on investment that reflect the risks of operating under that regime. TELRIC's terms expressly require such returns. As the FCC made explicit, TELRIC requires that depreciation and rate-of-return calculations reflect all the risks of operating

in an environment in which rates are based on the costs of efficiently replacing the particular network element at issue. Order, ¶ 687 (JA 385). On its face, TELRIC is thus a perfectly reasonable and valid method that requires consideration of all the relevant factors, and it palpably will not "necessarily" lead to uncompensated takings of property in any "identifiable class of cases." *Riverside Bayview Homes, Inc.*, 474 U.S. at 128 & n.5. Further, before the FCC, the LECs did not introduce any evidence that the necessary or even likely effect of the adoption of TELRIC could possibly be to jeopardize the "financial integrity" of their companies or of even any segment of them. Compare Order, ¶¶ 738-739 (JA 421-22), with *Duquesne*, 488 U.S. at 312.

Finally, the reason that the validity of rate orders depends entirely on their "end result" is that any ratemaking method can be applied in ways that either do or do not allow the utility to earn an appropriate risk-adjusted return on investment. Accordingly, forward-looking methodologies like TELRIC are no more likely to result in meritorious taking claims than are historical prudent-investment or other ratemaking methods.[25]

C. The LECs' Claims Of A "Switch" In Methodologies Are Legally Meritless And Depend On Erroneous Extrarecord Assertions.

The consideration of the LECs' taking-based claims can thus begin and end with the fact that there is no basis for a claim that TELRIC would result in rates that are confiscatory even if LECs' only business were the provision of network elements.

However, the LECs also make two related claims that purport to be based on the Takings Clause. Each rests on

---

[25] Indeed, there have been many recent cases in which utilities raised taking claims under prudent-investment regimes. *See infra* p. 44 nn.31-32.

assertions that the adoption of TELRIC represents a "switch" in ratemaking methodologies that will deny LECs the recovery of substantial costs that they putatively had a right to recover under the historical prudent cost method that purportedly governed their operations before TELRIC was adopted. First, the LECs rely on *Duquesne*'s statement that it would "raise serious constitutional questions" if an agency were "to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." 488 U.S. at 315. Second, the LECs' claim that the adoption of TELRIC breached a "regulatory compact" in which LECs made their network investments in exchange for a guarantee that they always would recover all of their historical investments.

These claims are legally baseless. Further, they rest on the LECs' extrarecord assertions that TELRIC has been, or might be, applied in particular ways. But these claims are out of order in an appeal from the "final agency action" that adopted TELRIC. Compare LEC Br. 37. In addition, the claims do not rest on competent evidence, and are demonstrably erroneous.

The basic fallacy of both LEC claims is that TELRIC simply does not represent a "switch" in ratemaking methodologies. The FCC's adoption of TELRIC to set interconnection and network elements rates has no effect on the ratemaking methods that govern the interstate and intrastate telecommunications services that LECs have historically provided. These services continue to be subject to the ratemaking methods that were in effect before the 1996 Act was adopted and implemented. For the same reasons, TELRIC does not "rewrit[e] the terms of thousands of regulatory transactions [long] closed" (*id.* at 30), and the rhetoric of "harsh retroactivity" and a regulatory "bait and switch" that pervades the LECs' Brief is simply inapt. *Id.* at 29, 30. That is particularly so because it has been the case for

more than a decade that the LECs have been subject to a price cap regime in which they did not have any right to a return on all historical prudent investment.

Rather than change the regulatory treatment of the LECs' existing interstate and intrastate telephone services, the FCC adopted TELRIC to govern the pricing of new wholesale arrangements – interconnections and network elements – that LECs were required to provide for the first time by virtue of the 1996 amendments to the Communications Act. By adopting TELRIC for this purpose, the FCC was following the same ratemaking method that governed the setting of rates for other essential facilities that LECs provide to their competitors. And while the new arrangements allow new entrants to offer local services that compete with those of the LECs, in the nearly five years since TELRIC was adopted, fewer than 3% of the nation's telephone lines have switched to firms that use unbundled network elements to offer competing services.[26]

1. TELRIC Is Not An Impermissible Switch In Methodologies That "Strands" Investment.

The "serious constitutional questions" that *Duquesne* identified arise only if an agency arbitrarily switches ratemaking methods back and forth "in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Duquesne*, 488 U.S. at 315. Here, there has been no switching of methods, much less switching back and forth. And the effect of the adoption of TELRIC was neither to require investors to bear the risk of bad investment nor to deny them the benefit of good ones. In short, the LECs

---

[26] Press Release, Federal Communications Comm'n, FCC Releases Latest Data on Local Telephone Competition (May 21, 2000) (new entrants serve 8.5% of lines, about one third of them using unbundled network elements).

simply have not made the showing that would, in *Duquesne*'s words, "raise serious constitutional questions." *Id.*

The LECs are thus reduced to contending that *Duquesne* adopted another very different rule, *sub silentio*. Specifically, they contend that, under *Duquesne*, a tribunal cannot lawfully adopt a forward-looking method unless it demonstrates that it will permit a utility to achieve rates that fall with the same range as would result from the operation of an historical prudent-investment method. LEC Br. 27. The LECs claim that the adoption of TELRIC violates this rule because it allegedly was "designed" to produce network valuations that are 50%-60% lower than those that would be produced under a historical-cost method. LEC Br. 40. In their view, it follows that TELRIC will unlawfully "strand" the LECs' prudent investment. These claims have no basis even apart from the LECs' misplaced reliance on the concept of "stranded investment."[27]

Duquesne did not adopt a rule under which regulatory agencies could depart from historical-cost methods only if they showed that the departure would have no substantial

---

[27] "Stranded" investment refers to "investments in specialized, durable assets that may have seemed necessary, or at least justifiable, when constructed and placed into service under a regime of price and entry controls but that have become underutilized or even useless under deregulation," such as an electric generation plant that is idled by an agency order requiring transmission of competitively generated power. H. Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L. J. 801, 802-03 (1999) (book review). Stranding would only occur under the Act if the LECs' network facilities became underutilized because competitors constructed and used alternative facilities. By contrast, when competitors provide service over leased network elements, no stranding occurs. *See* W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Service To Rivals*, 73 N.Y.U. L. Rev. 1122, 1143 (1998). Because the sole issue here relates to the rates LECs receive when they lease out their facilities, the LECs reliance on the FERC's stranded-cost orders is wholly misplaced, LEC Br. 12 n.8.

effect on the resulting rate levels. The object of all ratemaking is to foster efficiency and to prevent rates that recover inefficient or wasteful expenditures. The Federal Constitution could not preclude the adoption of a ratemaking method merely because it is more effective in carrying out these objects than the prudent-investment method (which the FCC previously determined to foster inefficiencies that regulators are incapable of preventing).

The LECs are simply wrong in arguing that *Duquesne* held otherwise. Their contentions rest only on the Court's statement that the utility had not claimed that the "total effect" of the revised rate order was unconstitutional, for this order differed in only *de minimis* ways from the prior order that the utility was seeking to reinstate. *Duquesne*, 488 U.S. at 311-12. That was a description of the two orders, not a statement of constitutional requirements.

Contrary to the LECs' misstatement (LEC Br. 9, 40), the FCC did not "adopt[] TELRIC with the *express purpose* of producing prices lower than historical costs." Rather, the FCC determined that the competitive goals of the Act demanded pricing based on economic costs, "which may be higher or lower than historical embedded costs." Order, ¶ 705 (JA 399). And, there is palpably no basis for the LECs' claim that the FCC adopted TELRIC because it was designed to value the LECs' networks at levels 50-60% lower than would a prudent historical-cost method. As explained above (*supra* pp. 8-13), these claims rest on extrarecord assertions that are unsupported, that rest on apples-to-oranges comparisons, and that are inconsistent with the very data sources upon which the LECs rely.

But even if the overall network valuations were certain to be lower under TELRIC, that would only raise the question of why this difference exists. If it were the product of facts that would have foreclosed the LECs' recovery of the difference under strict applications of a prudent-investment methodology, the difference obviously would have no

constitutional or other significance. For example, any prudent-investment regulator would exclude from the rate base the substantial amount of phantom assets that appear on the LECs' books, but that are not in use in the LECs' networks. *Continuing Prop. Records Audit*, 14 FCC Rcd. 7019, 7019 (¶ 1) (1999). It should similarly exclude the vast amounts of excess capacity the LECs have installed to provide unregulated enhanced services in the future. In this regard, a major reason that AT&T and others advocated TELRIC is that it is a very efficient way of determining how the LEC networks should be sized to meet existing demand and of preventing LECs from recovering from competitors the costs of present excess capacity that was installed to support the LECs' future competitive services.

Finally, even if TELRIC were certain to produce lower asset values and thus a lower "rate base" than would other ratemaking methods, the "end result" could still be the same. The effects of a lower TELRIC rate base "may well be cancelled out by countervailing errors or allowances in another part of the rate proceeding." *Duquesne*, 488 U.S. at 314. Indeed, the favorable effects of depreciation[28] or cost-of-capital[29] allowances may offset any effect of the different

---

[28] TELRIC permits economic depreciation that reflects expected price declines and the risk of obsolescence associated with technological change, Order, ¶ 686 (JA 384-85). That would result in higher depreciation allowances than the LECs receive under historical-cost methods, particularly if it were true (*compare* LEC Br. 4) that regulators require artificially prolonged useful lives.

[29] In *Duquesne Light Co.* v. *Barasch*, the Court held that the regulators' exclusion of certain prudent investments from a utility's rate base raised no constitutional issue, for the utility had received a rate-of-return higher than the minimum that would have been required under a prudent-investment method. 488 U.S. 299, 312 (1989). In making its determinations under TELRIC, the FCC currently uses a rate-of-return of 11.25%, which was established in 1990. *See supra* p. 5 n.1. That was an exceedingly generous rate-of-return even at that time, and because interest

methods for valuing the rate base. Thus, the "end result" could be the same under either method.

2. The LECs' Regulatory Compact Claim Is Meritless.

There is similarly no foundation for the LECs' suggestion that the adoption of TELRIC violated a regulatory compact in which they built local networks in exchange for a promise that they could recover their historical costs in rates. The LECs assert – without citation of authority – that under any constitutional ratemaking regime "investors expectations are settled by a predictable mechanism that informs investors in advance how they will be paid." LEC Br. 24. But that assertion is squarely foreclosed by *Duquesne*, which upheld a revised rate order that excluded $35 million of investment that was recoverable under the prior ratemaking method. 488 U.S. at 312-14. And while regulatory compacts can exist, the LECs simply are not parties to one.

First, contracts specifying regulatory duties and entitlements were sometimes entered into during the nineteenth-century, usually in the form of corporate charters to internal improvement corporations or franchises for use of the public right-of-way. See R. Seavoy, *The Origins Of The American Business Corporation, 1784-1855*, at 39-51 (1982). However, this Court then held that the power to regulate rates existed independently of any compact to dedicate property to public use. See *Munn* v. *Illinois*, 94 U.S. 113, 125-26, 133 (1876); *accord Nebbia* v. *New York*, 291 U.S. 502, 536-39 (1934). And rate regulation was imposed on the LECs after they had made their investment, not as the quid pro quo in a regulatory compact. See H. Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L. J. 801, 804-05 (1999) (book review).

---

rates and costs of equity are radically lower today, a much lower rate-of-return could now be applied under a prudent-investment regime.

Further, neither the state nor federal regulatory schemes ever guaranteed any LEC that it could recover all historical costs. To the contrary, the LECs expanded and maintained their networks subject to the very general standard that the rates must be "just and reasonable," which affords the agency considerable "pricing flexibility" to change methodologies as the public interest requires. *Mobil Oil Exploration & Producing S.E., Inc.*, 498 U.S. at 224. Under this regime, the LECs unilaterally decide which investments to make. To enforce the "just and reasonable" standard, regulators can review a LEC's investments long *after* they were made to decide whether they should be included, in whole or part, in the "rate base" under the policies that the regulatory body then chooses to apply. See Hovenkamp, *supra*, at 822.

Under these systems, it is well settled that even if a regulatory commission made an affirmative decision to include an investment in a rate case in one year, the commission may make a different determination in future years by either adopting a different policy or ratemaking standard or by applying its prior standard more rigorously. As this Court has held, "[t]he declaration of a specific policy creates no vested right in its maintenance in utilities then engaged in the business," *Tennessee Electric Power Co.* v. *TVA*, 306 U.S. 118, 141 (1939), and a court will not "set aside [a rate order] merely because the Commission has on an earlier occasion reached another result" under a different ratemaking standard. *Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968).

The fact that the regulatory environment was structured to encourage LECs to invest in their network to promote universal service does not create a binding obligation to base rates on historical costs. Unless the government has by express terms of a contract committed itself to a particular regulatory course, it is not bound to compensate a regulated entity that claims to have relied on the prior scheme. See *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996);

Louisville Bridge Co. v. *United States*, 242 U.S. 409, 420 (1917); J. Rossi, *The Irony of Deregulatory Takings*, 77 Tex. L. Rev. 297, 308-09 (1998) (book review). The LECs have no more right than any other entity to be compensated for the inability to recover all past investment due to regulatory change. Cf. *Keystone Bituminous Coal Ass'n* v. *DeBenedictis*, 480 U.S. 470, 495 (1987) (describing "regulatory takings").

III. THE FCC'S REJECTION OF THE LECS' HISTORICAL-COST PROPOSALS WAS NOT ARBITRARY AND CAPRICIOUS.

Finally, there is no substance to the LECs' claims that it was arbitrary and capricious for the FCC to reject historical-cost ratemaking and to adopt a forward-looking method. As this Court has held, the determination of the proper cost standard to use in setting rates is one of the "kind of basic judgments about economic policy" that is uniquely committed to the discretion of federal agencies and that courts are ill-suited to second-guess. *American Commercial Lines, Inc.* v. *Louisville & Nashville R.R.*, 392 U.S. 571, 590 (1968). Accordingly, to succeed on their claims, the LECs must show that the FCC failed "adequately [to] consider[] the factors relevant to choosing a rate that will best serve the purposes of the statute" and that it "committed a 'clear error of judgment'" in rejecting historical-cost ratemaking. *American Paper Inst., Inc.* v. *American Elec. Power Serv. Corp.*, 461 U.S. 402, 413 (1983). The LECs have not come close to satisfying this demanding standard.

Indeed, the reasonableness of the FCC's rejection of historical cost is established by the most elementary principles of economics and by the decade of regulatory and antitrust decisions that provided the background to the 1996 Act and that have been discussed throughout this brief.

First, the FCC and most states had determined that historical-cost ratemaking fosters inefficiencies that

regulators are incapable of controlling even in the very different context of regulating the LECs' overall revenues and earnings. The regulatory task in the performance of this function is merely determining the reasonable costs of a regulated firm as a whole and attempting to prevent it from earning monopoly profits. This function required no determinations of costs attributable to individual different facilities, functions, services, and locales. Nor did it present the regulated firm with incentives to misallocate costs among different facilities, functions, services, or areas to prevent or distort competition.

Second, the FCC and states had determined that historical-cost ratemaking methods are flatly inappropriate when the issue is establishing the conditions that will allow competition with retail services of the incumbent LEC. There is no truism more elementary in all of economics than that historical costs are irrelevant because they are "sunk" and "unavoidable,"[30] and that the relevant costs to decisionmaking in competitive markets are forward-looking costs. These are the "real" and "economic" costs that LECs incur when they use the essential facilities that they control to provide services at retail in competition with other firms. For that reason, these are the costs that the FCC and other regulatory bodies have long relied upon in determining the rates that LECs may charge prospective competitors for access to those essential facilities.

Against this background, to accept the LECs' claims that rates for network elements and interconnections should be based on historical cost, the FCC would have had to repudiate its own consistent prior decisions and the decisions of other regulatory bodies and antitrust authorities. AT&T Pet'rs' Br. 6-12. The notion that its failure to do so could have been arbitrary and capricious stands basic principles of

---

[30] A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987).

administrative law on their head. And there is not the slightest substance to the claims that the LECs have made.

A. All Ratemaking Methods Are Hypothetical And There Is No Basis For The Claim That Other Methods Would Fulfill The Act's Objectives At Lower Administrative And Other Costs.

The LECs' primary claim is that it was arbitrary to reject their historical-cost proposals because the alternative forward-looking method is "hypothetical" and difficult to administer. These contentions are baseless.

1. As Professors Baumol, Willig, and Ordover testified before the FCC, "*[a]ll* cost-based ratemaking standards (including embedded cost ratemaking) involve hypothetical constructs." Baumol et al. Reply Aff. at 6 n.4 (JA 147). Prudent historical-investment and replacement-cost methods are both "hypothetical" for each seeks to foster efficiency by determining not what the utility is spending, but what it should be spending. The only difference is that one method makes hypothetical determinations by looking "forward" and the other by looking "backward."

TELRIC and other efficient replacement-cost methods determine the particular facilities that are required to meet the existing demand and what it would cost to construct and operate them from the "bottom up." It thus determines what an appropriately sized network should cost by looking forward.

Prudent historical-investment ratemaking makes the same determination on a backward-looking basis. It begins with the utility's existing assets and determines whether they should have been configured differently. But it does so by examining all of the historical decisions that caused the existing configurations to decide whether they are ones that "'reasonable utility management . . . would have made, in good faith, under the same circumstances, and at the relevant point in time.'" *New Orleans* v. *FERC*, 67 F.3d 947, 954

(D.C. Cir. 1995). As Judge Levanthal stated, "a conclusion of imprudence reflects a view of how business should be conducted." *TWA, Inc.* v. *CAB*, 385 F.2d 648, 656 (D.C. Cir. 1967).

In circumstances where costs were rising rapidly and commissions had strong incentives to determine if utilities had acted inefficiently in ways that harm the public, applications of the prudent-investment methodology have entailed extraordinarily detailed retrospective reviews of all the stages in a utility's internal decisionmaking processes over long periods of time. Based on these archeological expeditions, commissions have made assessments of the reasonableness of each incremental investment made during that period.[31] When imprudence is found, commissions then determine what costs the utility would have incurred in the hypothetical world in which it had been prudent. These inquiries entail such things as deciding what costs would have been if construction of a new plant had or had not been temporarily halted, abandoned or accelerated; if the utility had or had not sold off certain facilities and purchased substitutes; or if the utility had managed itself differently in myriad other respects.[32]

2. One reason that leading economists urged a forward-looking method is that there is evidence the existing LEC networks are inefficient, contain phantom assets, and were intentionally overbuilt with capacity that is not needed to meet existing demand, but that will be used only to provide unregulated enhanced and other new services in the future.

---

[31] *See, e.g., Long Island Lighting Co.* v. *PSC*, 523 N.Y.S.2d 615 (N.Y. App. Div. 1987); *Kansas Gas & Elec. Co.* v. *State Corp. Comm'n*, 720 P.2d 1063 (Kan. 1986), *vacated in part*, 481 U.S. 1044 (1987); *Entergy Gulf States, Inc.* v. *Louisiana PSC*, 726 So.2d 870 (La. 1999).

[32] *See* cases cited in n.31. *See also, e.g., Consumers' Counsel* v. *FERC*, 914 F.2d 290, 296 (D.C. Cir. 1990); *Connecticut Light & Power Co.*, 43 FERC ¶ 63,029, at 65,228, 65,231 (1988).

See *supra* pp. 7-8. In this context, TELRIC and other forward-looking methods are the lowest cost methods of determining the efficient level of investment required to meet the existing demand, for they simply size and then cost a network from the "bottom up."

By contrast, the administrative and litigation costs of rigorously making these same determination under a backward-looking historical-cost method would be prohibitive. It would require penetrating the LECs' books and reviewing years of network planning decisions. The problems would have been radically compounded by the fact that the objective of the 1996 Act is not to determine the LECs' average statewide costs, but to determine the costs that LECs incur in providing services in discrete areas having different population densities and terrain. Order, ¶ 965 (JA 439). Because the LECs' historical costs are kept on state-wide or similar bases, this would have required allocations of book costs that would be complex and arbitrary. In short, the LECs have it exactly backwards in claiming that a prudent historical-cost approach would have helped in "speeding the transition to competition." LEC Br. 46. If rigorously applied in an attempt to foster the Act's procompetitive goals, a prudent-investment method would be slower, not speedier, and more expensive, not cheaper. Furthermore, as the FCC found, the end result of that process likely would have been rates that impede or foreclose competition, not rates that promote it. Order, ¶ 705 (JA 398-99).

3. The LECs' claims that forward-looking costing is administratively infeasible rest primarily on Justice Brandeis's 1923 opinion that criticized fair value ratemaking and summarized his reasons for then believing prudent-investment methods could achieve the same benefits at lesser costs. LEC Br. 45. But Justice Brandeis was addressing the determinations of the costs of service of an entire firm based on its books – where the sole object is to prevent the firm

from earning monopoly profits.[33] He was not addressing the matter of determining the cost of providing different facilities and functions in different locales – where the object is to assure that incumbent monopolists and their competitors obtain the same essential facilities at the same economic costs. Justice Brandeis also made his statements before there had been any experience with prudent-investment ratemaking, much less the experience that caused it to be rejected by the FCC and most states for the purpose for which Justice Brandeis had thought it to be well suited. This was also long before replacement cost pricing was not only proven eminently feasible, but also became commonplace, by the developments in computer modeling in more recent decades. Finally, Justice Brandeis manifestly did not argue that a commission should be required to use prudent investment if it determined based on experience that another method would be more effective for a different purpose.

The reality is that by 1996, forward-looking incremental costing approaches were the norm in this context. They had been successfully used for years by states in setting LEC prices for individual services and facilities, and the states had begun to apply long run incremental cost ("LRIC") methods to the pricing of network elements. See Order, ¶ 631 (JA 334-36). Indeed, they are such a staple of state regulatory oversight that LRIC cost studies are required by statute in many jurisdictions.[34] LRIC had been used by antitrust courts in resolving claims that Bell companies had engaged in predatory pricing by pricing individual services below their

---

[33] Similarly, this was the subject matter of the FCC's 1992 Order that adopted historical-cost regulation to regulate retail cable television rates. *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, 9 F.C.C.R. 4527 (1994).

[34] 220 Ill. Comp. Stat. 5/13-502(c); Mich. Comp. Laws Ann. § 484.2208(9); Minn. Stat. Ann. §§ 237.59, 237.772; Tex. Util. Code Ann. § 58.055(c); Utah Code Ann. § 54-8b-3.3(5); Wy. Stat. Ann. § 37-15-402(a).

relevant costs; by the Surface Transportation Board in pricing railroad services; and now has been adopted by the European Commission in opening its local markets to competition. See AT&T Pet'rs' Br. 8-12, 19-21, 32-33. The LECs also ignore that the FCC's thoughtful and well-supported predictive judgment has been proven correct – notwithstanding the LECs' claims of administrative unfeasibility, virtually all states have, in fact, managed to apply forward-looking pricing principles to estimate efficient replacement costs and establish network element and interconnection rates. See *id.* at 21 n.23.[35]

In light of this experience, the LECs grasp at straws in contending that the FCC did not provide adequate explanation of the administrability of TELRIC. Indeed, in addition to relying on the state regulatory experience, the FCC conducted "an initial examination" of various LRIC computer models that were submitted for the record, and concluded that "the remaining practical and empirical issues can be resolved in the near future." Order, ¶ 835 (JA 433).

Certainly, the FCC's expert determination of what methods are most cost effective is entitled to substantial deference, particularly where, as here, most of the LECs' complaints about administrability are simply anachronistic.

---

[35] The LECs falsely claim that it took the FCC four years "of revising and updating various cost models" to "finally decide that TELRIC could be used to project costs accurately." Br. at 45. In fact, the FCC never wavered from its initial proposal that universal service costs, like network element and interconnection rates, should reflect forward-looking costs. And the proceedings to choose a particular cost model and inputs were completed in less than twenty-eight months, *Federal-State Joint Bd. on Universal Serv.*, 14 FCC Rcd. 20156, 20161 (¶ 5) (1999), notwithstanding the LECs' steadfast refusal to cooperate and provide customer location and other data within their sole control.

B. Competitive Pricing Of Network Elements Does Not Frustrate The Act's Purposes.

In the last two pages of their brief, the LECs make five cursory arguments that TELRIC is contrary to the Act. LEC Br. 48-49. One is a claim that they promise to elaborate on in their response brief to AT&T's and the FCC's appeal. AT&T will address that argument in its Petitioner's Reply Brief. The other four arguments can be summarily dismissed.

First, relying on an out-of-context statement from Justice Breyer's separate opinion in *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. 366, 424 (1999), the LECs claim that the adoption of TELRIC short-circuits the "process" of competition and seeks to mandate a set of retail prices that would represent the "'end result'" of competition. LEC Br. 48 (emphasis omitted). But Justice Breyer addressed the initial FCC rules in which there was no "limit" on the facilities that could be leased as network elements under TELRIC. Under the FCC's current rules, the only facilities that can be leased from the LECs are those that competitors plainly need to offer competing services. As the FCC's findings establish, the availability of these facilities at TELRIC-based rates is thus necessary for competition to develop in the "unshared" parts of the network and to begin a "process" that will drive retail prices closer to competitive levels. Compare 525 U.S. at 430. By contrast, as the FCC found, if LECs could impose higher prices under a historical-cost method, the LECs could foreclose even the limited competition that has developed in the last five years. Order, ¶ 705 (JA 398-99).

Second, LECs claim that the FCC did not justify its assertions that historical costs would foster inefficient entry, and wonder how higher rates could induce inefficient competitors to enter the market. But the FCC's point, fully explained in the order, was that the entry – not the entrants – would be inefficient if prices did not reflect true economic costs. The FCC repeatedly pointed out that inflated network

element rates provide improper price signals and would cause investments in facilities that LECs can provide at a lower economic cost than any new entrant. See Order, ¶¶ 620, 635-636, 679, 708-711 (JA 327-28, 340-43, 379-80, 401-03).

Third, the LECs claim that the FCC ignored the threat to genuine competition from UNE prices that are too low. The LECs here simply repeat their unfounded claim that TELRIC does not represent the economic costs of providing the elements. If prices for essential inputs are set at economic costs, there is no underpricing. Moreover, given the high transactions costs of leasing network elements, new entrants still have ample inducement to engage in facilities-based competition, as AT&T is doing. See AT&T Pet'rs' Br. 14-15. In any event, Congress did not favor one entry strategy over another, Order ¶ 12 (JA 271-72), and efficiency in network element rates is not to be sacrificed based on projected and dubious effects on facilities-based competition.

Finally, the LECs renew their regulatory-compact arguments, now under the arbitrary-and-capricious banner, claiming that the opportunistic changing of regulatory rules will be a disincentive to future investment. But it is Congress that has set the rules of this game; the FCC has simply adopted methods consistent with those rules and suited for the new competitive environment. Moreover, TELRIC is structured to ensure a return on investment, see *supra* pp. 21-23, and it gives the same incentives to capital investment as exist in a competitive market.

CONCLUSION

For the reasons stated, the Eighth Circuit decision should be affirmed insofar as it upheld forward-looking pricing.

Respectfully submitted,

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY AUSTIN BROWN & WOOD
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Respondent

June 8, 2001

* Counsel of Record

Supreme Court, U.S.
FILED
JUN 8 2001
OFFICE OF THE CLERK

JUN 8 2001

(19) (18) (15) (16) (16)

No. 00-511, 00-555, 00-587, 00-590 and 00602

IN THE
Supreme Court of the United States
OCTOBER TERM 2000

VERIZON COMMUNICATIONS INC., ET. AL,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF RESPONDENTS PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK AND NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS ON THE MERITS

LAWRENCE G. MALONE
General Counsel
PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK
THREE EMPIRE STATE PLAZA
ALBANY, NY 12223-1350
(518) 474-2510

JAMES BRADFORD RAMSAY*
General Counsel
SHARLA BARKLIND
Assistant General Counsel
NATIONAL ASSOCIATION OF
REGULATORY UTILITY
COMMISSIONERS
1101 VERMONT AVE, NW, #200
WASHINGTON, DC
(202) 898-2207

* Counsel of Record

August 6, 2001

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether a regulated utility can claim a 5th Amendment unlawful confiscation from an agency's use of a forward-looking methodology where that utility fails to demonstrate the challenged order will have a significant adverse impact on its financial condition?

LIST OF PARTIES BELOW AND RULE 29.6 CERTIFICATION

Pursuant to U.S. Sup.Ct. Rule 29.6, 28 U.S.C.A., Respondents state as follows:

The New York Public Service Commission is the State governmental body charged by law with responsibility for setting rates and ensuring that adequate service is provided by New York's public utilities. As a public utility commission it does not need to file a corporate disclosure statement.

The National Association of Regulatory Utility Commissioners ("NARUC") is supported predominantly by dues paid by its State public utility commission members and through revenues generated by three meetings each year of those members. NARUC has no parent company, subsidiary, or affiliate.

The Parties to the proceeding before the 8th Circuit follow: Airtouch Communications, Inc., Alabama Public Service Commission, Association For Local Telecommunications Service, AT&T Corporation, Bell Atlantic Corporation, Bellsouth Corporation, California Public Service Commission, Competitive Telecommunications Association, Cable & Wireless Company, Colorado Attorney General's Office, Federal Communications Commission, Georgia Consumers' Utility Counsel Division, GTE Service Corporation, Iowa Utilities Board, Kentucky Public Service Commission, Massachusetts Department of Telecommunications and Energy, Maryland Public Service Commission, Mississippi Public Service Commission , Montana Public Service Commission, New York State Department of Public Service, National Association Of State Utility Consumer Advocates, National Telephone

LIST OF PARTIES BELOW (CONTINUED)

Cooperative Association, North Carolina Utilities Commission, National Association of Regulatory Utility Commissioners, SBC Communications, Inc., Organization For The Protection And Advancement Of Small Telephone Companies, Oregon Dept. Of Justice, Pennsylvania Public Utility Commission, South Dakota Public Service Commission , Southwestern Bell Telephone, Southern New England Telecommunications Corporation, Texas Office Of Public Utility Counsel, Texas Attorney General, United States Telephone Association, Wisconsin Public Service Commission, US West, Inc., United States Of America, Verizon Services Group, Virginia State Corporation Commission.

TABLE OF CONTENTS

QUESTIONS PRESENTED i

LIST OF PARTIES AND AFFILIATES ii

TABLE OF AUTHORITIES iv

INTRODUCTION 1

OPINIONS BELOW 3

JURISDICTION 3

RELEVANT CONSTITUTIONAL /STATUTORY PROVISIONS ... 4

STATEMENT OF THE CASE 4

SUMMARY OF ARGUMENT 7

ARGUMENT: PETITIONERS' STATUTORY AND CONSTITUTIONAL CRITICISMS OF PRICES BASED ON FORWARD-LOOKING PRICING METHODOLOGIES LACK SUBSTANCE 8

A. PETITIONERS' READING OF SECTION 252(D)(1) IS INCORRECT 8

B. PETITIONERS' TAKINGS ARGUMENTS ARE PREMATURE 15

C. PETITIONERS' CONSTITUTIONAL ARGUMENTS MISCONSTRUE EXISTING PRECEDENT 18

CONCLUSION 28

TABLE OF AUTHORITIES

CASE **PAGE**

Alenco Communications, Inc., et al. v. FCC,
201 F.3rd 608 (5th Cir. 2000)....21 n22

Alabama Elec. Coop. Inc. v. FERC,
684 F2d 20 (D.C. Cir. 1982)....9 n4

Appalachian Power co. v. EPA,
135 F.3d 791(D.C. Cir. 1998)....9 n4

AT&T Corp. v. Iowa Utilities Board,
525 U.S. 366 (1999)....2,6, 8 n2,13 n13

Bell Atlantic-Delaware, Inc. v. McMahon,
80 F. Supp. 2d 218, 235-36 (D. Del. 2000)....13 n14

Duquesne Light Co. v. Barasch,
488 U.S. 299 (1989)....3, 14, 20, 20 n21, 25 n 28, 26

FPC v. Hope Natural Gas Co.,
320 U.S. 591 (1944)...3, 14,19, 20, 20 n20, 21,24,25,
25 n 27, 28 n 30

GTE South Inc. v. Morrison,
6 F. Supp. 2d 517, 528-30 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-44, 749 (4th Cir. 1999)....9 n2, 13 n14

CASE **PAGE**

Indianapolis Power and Light Co. v. ICC,
587 F.2d 1098 (7th Cir. 1982)....2 n1

Iowa Utilities Board, et al v. FCC
120 F.3d 753 (8th Cir. 1997)....6

Iowa Utilities Board, et al v. FCC,
219 F. 3rd 744, 757 (8th Cir 2000)....3, 13 n13

Jersey Central Power & Light Co. v. FERC,
810 F.2d 1168 (D.C. Cir. 1987)....26 n29

Long Island Lighting Co v. Cuomo,
666 F. Supp. 370 (N.D.N.Y. 1987)....15 n 15

MacDonald, Sommer & Frates v. Yolo County,
477 U.S. 340, 348 (1986)....15 n 15

MCI Telecommunications Corp. v. Public Serv. Comm'n,
108 A.D.2d 285, 295 (3rd Dep't 1985), appeal withdrawn, 66 N.Y.2d 760 (1985)....11 n 8

Missouri ex rel Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 290 (1923)....19

Natural Gas Pipeline Co.,
315 U.S. 575 (1942).... 21, 22, 23, 24 n 24

CASE — PAGE

NEPCO Municipal Rate Committee v. FERC, 668 F.2d 1327 (1981)..... 25

Niagara Mohawk Power Corp. v. Public Serv. Comm'n, 69 N.Y.2d 365 (1987)..... 10 n7

Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978)..... 15 n15

In re: Permian Basin Area Rate Cases, 390 U.S. 747 (1968)..... 11 n9, 20 n 20

Smith v. Illinois Bell Telephone Co., 22 U.S. 133 (1930)..... 15 n 16

Smyth v. Ames, 169 U.S. 466 (1898)..... 19 n 19

Southwestern Bell Telephone v. Public Serv. Comm'n of Mo, 262 U.S. 276 (1923)..... 27 n30

Strickland v. Commissioner, Maine Dep't of Human Resources, 48 F.3d 12(1st Cir. 1995)..... 9 n4

Strickland v. Commissioner, Maine Dep't of Human Resources, 96 F3d 542(1st Cir. 1996)..... 9 n4

United States v. Riverside Bayview Homes, 474 U.S. 121 (1985)..... 21 n 22

CASE — PAGE

United States v. Southern Motor Carrier Rate Conf. et al., 467 F.Supp. 471 (N.D. Ga. 1979), aff. 672 F.2d 469 (5th Cir. Unit "B" 1982); aff. en banc, 702 F.2d 532 (5th Cir. Unit "B" 1983, rev'd, 471 U.S. 48 (1985) 2 n1

Washington Utilities and Transportation Commission, 513 F.2d 1142 (9th Cir. 1976)..... 2 n1

West Texas Util. Co. v. Burlington N.R.R., Docket No. 41191 (Surface Trans. Bd. May 3, 1996), aff'd, Burlington N.R.R. v. Surface Transp. Bd., 114 F.3d 206 (D.C. Cir. 1997)..... 12 n11

CONSTITUTIONAL PROVISIONS:

U. S. CONST. Amend. V..... *passim*

STATUTES

Communications Act of 1934, as amended by the *Telecommunications Act of 1996*, 47 U.S.C. § 151 *et seq.*, Pub.L. No. 101-104, 110 Stat. 56 (1996) (West Supp. 1998) ("1996 Act" or "Act" or "FTA")..... *passim*

28 U.S.C. § 1254(1)..... 3

47 U.S.C. § 151..... 4

47 U.S.C. § 252..... *passim*

47 U.S.C. § 251(c)(2)..... 5

47 U.S.C. § 252(d)(1) 5, 7, 8
47 U.S.C. § 254 ..... 1 n2
47 U.S.C. § 410(c) 1 n1
47 C.F.R. §§ 51.1-51.809 3

SUPREME COURT RULES

U.S. Sup. Ct. Rule 29.6, 28 U.S.C.A. ii

ADMINISTRATIVE DECISIONS

In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order,
11 FCC Rd. 15499 (August 1, 1996) 3, 4, 5

In re Federal-State Joint Board on Universal Service, Tenth Report and Order,
14 FCC Rcd 20156 (Nov. 2, 1999) ..... 27 n 30

Statement of Policy on Test Periods in Major Rate Proceedings,
22 PUR4th 611, 17 NY PSC 25-R (1977) ..... 10 n 7

In re: Open Access to Bottleneck Services and a Framework for Network Architecture Development of Dominant Carrier Networks, "Interim Opinion Adopting Cost Methodology Principles and a List of Basic Network Functions for Which Cost Studies Are to Be Perform", Decision 95-1-016,
62 CPUC 2nd 575, (December 6, 1995) 12 n12

In the Matter of the Joint Application of Sprint Communications Company L.P. et al. for the Commission to

Open a Generic Proceeding on Southwestern Bell Telephone Company's Rates for Interconnection, Unbundled Elements, Transport and Termination, and Resale, "Order Granting Southwestern Bell Telephone Company's Petition for Reconsideration of Order on Reconsideration/Clarification Date June 23, 2000," Docket No. 97-SCCC-149-GIT, Kansas Corporation Commission
(July 27, 2000) 13 n14

MISCELLANEOUS

1999 Statistics of Communications Common Carriers, at Table 2.9 (Account 350) (rel. Aug. 11, 2000), URL: http://www.fcc.gov/bureaus/common-carrier/reports/fcc-state_link/socc/99s0cc.pdf. ..... 16 n 17

Gabel, David, and Rosenbaum, David I., *Who's Taking Whom?*, 52 Fed. Comm. L.J. 239 (2000) 17 n18

Huber, Peter W., Kellogg, Michael K., and Thorne, John, *Federal Telecommunications Law*,
§ 2.4.4.1, at 185 (2d ed. 1999) 13

Kahn, A., *The Economics of Regulation: Principles and Institutions*, Vol.1, "Economic Principles,"
p. 26 (1970) 10 n5

Siegal, Joel G. and. Shim, Jae K., *Dictionary of Accounting* (2d ed. 1995) 9 n4

Trebing, Harry, *Review of "Deregulatory Takings and the Regulatory Contract"*, Telecommunications Policy,
24 (Pergamon 2000) 17 n18

IN THE
Supreme Court of the United States
OCTOBER TERM 2000

VERIZON COMMUNICATIONS INC., ET. AL,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF RESPONDENTS PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK AND NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

INTRODUCTION

The National Association of Regulatory Utility Commissioners ("NARUC") is a quasi-governmental nonprofit organization founded in 1889. NARUC represents those government officials in the fifty States, the District of Columbia, Puerto Rico, and the Virgin Islands, charged with the duty of regulating, *inter alia*, the telecommunications common carriers within their respective borders. [1]

---

[1] Both the United States Congress and federal courts have recognized that NARUC is a proper party to represent the collective interest
footnote continued on next page

NARUC's State commission members, including co-respondent the Public Service Commission of the State of New York, strongly oppose the arguments presented by incumbent Local Exchange Carrier (ILEC) petitioners Verizon Entities, BellSouth Corporation, SBC Communications Inc. and the United States Telecom Association (*hereinafter* "ILECs" or "Petitioners") for review. A Supreme Court decision upholding ILECs' confiscation claims on the basis of Petitioners' flawed analysis of the statutory text and related Constitutional provisions would ignore both the history of regulation and this Court's precedent on takings issues. It also would have an obvious adverse impact across the range of State and

---

of the State regulatory commissions. See, e.g., 47 U.S.C. § 410 (1986), where Congress calls NARUC "the national organization of the State commissions" responsible for economic and safety regulation of the intrastate operation of carriers and utilities. Cf, 47 U.S.C. § 254 (1996) (J.A. 29). See, also, *USA v. Southern Motor Carrier Rate Conference, et al.*, 467 F.Supp. 471 (N.D. Ga. 1979), aff. 672 F.2d 469 (5th Cir. Unit "B" 1982); aff. en banc, 702 F.2d 532 (5th Cir. Unit "B" 1983, rev'd, 471 U.S. 48 (1985). See, also *Indianapolis Power and Light Co. v. ICC*, 587 F.2d 1098 (7th Cir. 1982); *Washington Utilities and Transportation Commission v. FCC*, 513 F.2d 1142 (9th Cir. 1976). NARUC is a party to this proceeding. NARUC filed the first appeal of the FCC order that is the basis of the 8th Circuit decision on review and participated in this Court's first review (and reversal) of the 8th Circuit's determinations on State commission authority issues. Subsequently, after the 8th Circuit issued the decision up for review in this proceeding (partially vacating the FCC pricing methodology), NARUC also filed with the 8th Circuit supporting the FCC's request for a stay of mandate pending the FCC's petition for a writ of certorari.

Federal energy, water, and telecommunications utility regulation that has for years relied on forward-looking cost methodologies. As outlined in more detail *infra*, this Court's decisions in *FPC v. Hope Natural Gas Co. ("Hope")*, 320 U.S. 591, 602 (1944), as later affirmed by *Duquesne Light Co. v. Barasch ("Duquesne")*, 488 U.S. 299, 307, 102 L. Ed. 2d 646, 109 S. Ct. 609 (1989), has made modern utility regulation possible by providing regulators with great flexibility to try different methods as long as the overall process and outcome are reasonable. Petitioners have provided no reason for this Court to undercut that flexibility.

OPINIONS AND ORDERS BELOW

The opinion of the Eighth Circuit Court of Appeals is reported at *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000) ("*Iowa III*"). That decision reviews the Federal Communications Commission's "First Report and Order", *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15499 (1996) (J.A., 500) ("*Local Competition Order*") and the accompanying regulations codified at 47 C.F.R. §§ 51.1-51.809. The relevant regulations are reprinted in Petitioners' brief ("ILEC Brief") appendix at pages 28a –34a.

JURISDICTION

This Court has jurisdiction of this matter pursuant to 28 U.S.C. § 1254(1).

RELEVANT CONSTITUTIONAL PROVISIONS AND STATUTES

This matter involves the Takings Clause of the Fifth Amendment to the United States Constitution, U.S. Const. amend. V; and the *Communications Act of 1934*, as amended by the *Telecommunications Act of 1996*, 47 U.S.C. § 151 *et seq.*, Pub.L. No. 101-104, 110 Stat. 56 (1996) (West Supp. 1998).

STATEMENT OF THE CASE

The ILECs have petitioned for review of the Eighth Circuit Court of Appeals decision in the matter of *Iowa Utilities Board, et al. v. Federal Communications Commission and the United States of America*, 219 F.3d 744 (8th Cir. 2000)("*Iowa III*"). The *Iowa III* case disposed of challenges to a Federal Communications Commission ("FCC" or "Commission") order outlining, *inter alia*, pricing standards for NARUC's member commissions to use in arbitrations under Section 252 of the Telecommunications Act of 1996 ("Telecom Act" or "Act"). See *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report & Order, 11 F.C.C.R. 15499 (J.A., 500) ("*Local Competition Order*").

Sections 251 and 252 of the Telecom Act outline certain obligations for incumbent local exchange carriers ("ILECs") as part of the Act's effort to open up local phone markets to competition. Section 251 requires the ILECs to allow their competitors, competitive local exchange carriers ("CLECs"), to interconnect with their network and use those

facilities to provide competing local phone service. *See*, 47 U.S.C. § 251. Such interconnection must be at least equal in quality to that provided by the ILEC to itself or to any other party to which the carrier provides interconnection at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(2). ILECs must also provide such access to individual network elements on an unbundled basis at rates, terms and conditions that are just, reasonable and nondiscriminatory. 47 U.S.C. § 251(c)(3).

In Section 252, Congress articulated procedures for negotiating, arbitrating and approving the interconnection agreements as well as the rates for unbundled elements. Specifically, § 252 provides that rates for interconnection of facilities and unbundled elements required in § 251 shall be just and reasonable and based on the cost (determined without reference to a rate of return or other rate-based proceeding) of providing the interconnection or network element. 47 U.S.C. § 252(d)(1). The section also requires the rates to be nondiscriminatory and allows inclusion of "reasonable profit." The FCC's *Local Competition Order* adopted initial rules designed to implement §§ 251 and 252. *Local Competition Order* at 15507 (J.A., 268). Included in those rules were provisions outlining the pricing methodologies States must use to set prices for interconnection under § 252 if the ILEC and CLEC cannot reach their own agreement. *Id.* at 15812 (J.A. 325-7). The order establishes a forward-looking cost methodology known as Total Element Long Run Incremental Cost ("TELRIC") that sets prices of interconnection and access to unbundled

elements based on forward-looking, economic costs that best replicate, to the extent possible, the conditions of a competitive market. *Id.* at 15846 (J.A. 379-380).

Petitioners argue the FCC's forward-looking pricing methodology, *inter alia*, will not allow the company to recover all the costs it incurs meeting its interconnection obligations. ILEC Brief at 28. Petitioners contend the FCC's TELRIC rules devalue the existing network and undercompensate carriers for the network elements they are compelled to provide to CLECs under the Telecom Act. *Id.*

This is the second time this Court has accepted a writ to review an 8th Circuit decision addressing the FCC's *Local Competition Order*. In *AT&T Corp v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) ("*Iowa II*"), this Court affirmed in part, reversed in part, and remanded the 8th Circuit's original decision, *Iowa Utils. Bd. v. F.C.C.*, 120 F.3d 753 (8th Cir. 1997) *("Iowa I")*, vacating, in part, rules established in the *Local Competition Order*. *See*, *Iowa III*. At that time, this Court, *inter alia*, reversed the portion of the 8th Circuit's opinion pertaining to State commission authority and held that the FCC had jurisdiction to design a pricing methodology. *Id.* at 748. On remand, the 8th Circuit reviewed the merits of the FCC's forward-looking pricing methodology, proxy prices and wholesale pricing provisions. *Id.* Petitioners petitioned for review of that decision, *inter alia*, generically challenging the constitutional validity of TELRIC as a pricing methodology.

Respondents submit this Brief in opposition to the ILECs. In particular, Respondents urge this Court to reject arguments that the order below is confiscatory or violates the Takings Clause of the Fifth Amendment to the United States Constitution.

SUMMARY OF ARGUMENT

Petitioners misconstrue § 252(d)(1), insisting that ratemaking is traditionally a retrospective exercise, designed to allow utilities to recover "historical cost" and that the FCC's forward-looking TELRIC methodology used to set rates is, therefore, *ultra vires* and irrational. This construction is not supported by either the history of regulation generally or the specific language of the statute. Ratemaking is inherently a prospective, forward-looking exercise and State commissions have historically utilized forward-looking cost methodologies in setting rates. Additionally, Petitioners cannot claim an unconstitutional confiscation simply based on the allegation that the FCC chose the wrong methodology. The method employed to arrive at the rates of the utility is not determinative. If the total effect of the rate order is not unreasonable, i.e., it does not jeopardize the Petitioners' financial integrity, this Court's prior decisions indicate there is no regulatory takings claim. Neither Petitioners' brief, nor the record in this proceeding, includes sufficient evidence to support a claim that the FCC's orders result in an uncompensated taking under the 5th Amendment.

ARGUMENT

PETITIONER'S STATUTORY AND CONSTITUTIONAL CRITICISMS OF PRICES BASED ON FORWARD-LOOKING PRICING METHODOLOGIES LACK SUBSTANCE.

Petitioners contend the FCC's rules requiring States to base incumbent local exchange companies' charges to competitors on the incumbents' total element long-run incremental costs ("TELRIC") are inconsistent with § 252(d)(1) of the Communications Act (ILEC Brief 19-23) and violate the Fifth Amendment's prohibition against government confiscation of private property (ILEC Brief 23-44). As discussed, *infra*, the Petitioners' reading of § 252(d)(1) is simply incorrect. Moreover, their constitutional arguments are at best premature, misconstrue existing precedent, and lack record support.

A. PETITIONERS' READING OF § 252(d)(1) IS INCORRECT

This Court recently specified the 1996 Act delegates to the FCC the task of establishing a rate-setting methodology to advance the Act's goal of transforming the monopoly rate-of-return regime for local telephone service into a competitive market. Ignoring the implications of this Court's findings,[2] the ILECs argue that § 252(d)(1)'s use of

---

2 See *AT&T Corp. v. Iowa Utils. Bd.* ("*Iowa I*"), 525 U.S. at 397, 405; *Id.* at 423 (Sep. opinion of Breyer, J.) ("The statute sets forth those

footnote continued on next page

the word "costs" must necessarily be equated with "historical costs" based on either a "plain reading" of the statute or the allegation that "the term {"cost"} has acquired a fixed meaning in that context." ILEC Brief at 20. Neither rationale is convincing. The federal court decisions[3] consistently rejecting arguments that the States' widespread adoption of forward-looking costing methodologies violated the 1996 Act undermines any suggestion that the "plain meaning" of the section rigidly specifies reference only to "historical" cost. Indeed, the courts have routinely recognized that a statutory requirement of cost-based rates does not prescribe any specific measure of cost.[4]

---

standards in general terms, using such words as, "based on ... cost," "nondiscriminatory," and "just and reasonable." Terms such as these give rate-setting commissions broad methodological leeway; they say little about the "method employed" to determine a particular rate"). Cf *GTE v. Morrison*, 6 F.Supp.2d 517, 529 (E.D. Va. 1998) ("Historical costs are determined in a rate-of-return or other rate based proceeding. . Therefore, they are excluded by § 252(d)(1)(A).")

3 See footnote 14, *infra.*

4 See, e.g., *Strickland v. Commissioner, Maine Dep't of Human Resources*, 48 F.3d 12, 19 (1st Cir. 1995) ("[T]he word 'cost' is a chameleon."); *Strickland v. Commissioner, Maine Dep't of Human Resources*, 96 F3d 542, 546 (1st Cir. 1996) (there is "ambiguity inherent in the word 'cost,'" and absent explicit congressional guidance, courts cannot conclude. . .Congress has "spoken directly"; *Appalachian Power co. v. EPA*, 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word" cost); *Alabama Elec. Coop. Inc. v. FERC*, 684 F2d 20, 27 (D.C. Cir. 1982); Cf.. Siegel, Joel G., *Dictionary of Accounting Terms, 3rd Ed* (term "cost" is "virtually meaningless without an indication of the type of cost, such as incremental cost, variable cost,

footnote continued on next page

To support the notion that ratemaking is primarily designed to allow utilities to recover "historical cost" (ILEC Brief at 19) and that the FCC's forward-looking TELRICs are, therefore, *ultra vires* (*Id.* at 19-23) and irrational (*Id.* at 44-49), Petitioners also erroneously insist that ratemaking is traditionally a retrospective exercise.

Although there are many acceptable methods for setting utility rates (e.g., cost of service debt service; comparison to surrounding utilities), *ratemaking is essentially a prospective, forward-looking, exercise.*[5] Regulatory commissions, therefore, often design rates to recover the costs they expect a utility to incur in a future "rate year."[6] Commissions examine: (1) the revenues the company is expected to earn, at current rates; (2) the prudent[7]

---

fixed cost, replacement cost or historical cost.").

5 A. Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. 1, Economic Principles, p. 26 (1970).

6 See, e.g., *Statement of Policy on Test Periods in Major Rate Proceedings*, 22 PUR4th 611, 17 NY PSC 25-R (1977).

7 In a free market economy, competition forces shareholders to bear the consequences of management imprudence because the seller who attempts to recover imprudent costs in prices will lose customers. Competitive local exchange customers -- and retail ratepayers, in many areas, for that matter -- do not have the luxury of taking their business elsewhere if incumbent telephone companies charge prices that reflect wasteful practices. In order to spare consumers of monopoly services the effects of company imprudence, regulatory agencies set rates that recover

footnote continued on next page

operating expenditures the company is projected to incur during the period for which rates are being set; (3) the future rate base, or capitalization on which the company will earn a return; and (4) the rate of return that the company will need during the future period to cover the company's cost of raising capital. Once a regulatory agency establishes a company's overall revenue requirement, it develops a rate structure to recover the revenue requirement on a company-wide basis. Development of the rate structure begins with an allocation of the revenue requirement to the various services that the company offers. Next, the Commission designs rates for each service relying not only on projected costs, but on factors such as "the value of service to a class of customers,"[8] minimization of rate impacts and other factors.[9]

Thus, each service may or may not support its precise share of the revenue requirement. The Petitioners' claim that traditional ratemaking is retrospective and that Congress necessarily intended wholesale rates set under § 252 to recover historic costs is simply incorrect.

---

prospectively only costs that are prudent. See, e.g., *Niagara Mohawk Power Corp. v. Public Serv. Comm'n*, 69 N.Y.2d 365 (1987).

8 See, e.g., *MCI Telecommunications Corp. v. Public Serv. Comm'n*, 108 A.D.2d 285, 295 (3rd Dep't 1985), appeal withdrawn, 66 N.Y.2d 760 (1985).

9 *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

In an effort to buttress this argument, the ILECs argue that TELRIC, (and, necessarily by implication, the use of forward-looking costing methodologies generally), are "unmanageable" or "unworkable."[10] Again, this argument ignores the facts. Even before the 1996 Telecommunications Act, State and Federal regulators found that the best regulatory policy initiatives, in a variety of contexts, require the use of forward-looking costs. For example, the Interstate Commerce Commission, and its successor, the Surface Transportation Board, regulated railroad rates on the basis of forward-looking costs.[11] Similarly, California, Oregon, New York and others were initiating policies that required the use of forward-looking costs well before the Act's passage in 1996.[12]

---

10 See ILEC Brief at 45-46.

11 See, e.g., *West Texas Util. Co. v. Burlington* N.R.R., Docket No. 41191 (Surface Trans. Bd. May 3, 1996), aff'd, *Burlington N.R.R. v. Surface Transp. Bd.*, 114 F.3d 206 (D.C. Cir. 1997).

12 See, e.g., California's pre-Telecom Act "Interim Opinion Adopting Cost Methodology Principles and a List of Basic Network Functions for Which Cost Studies Are to Be Perform", *In re: Open Access to Bottleneck Services and a Framework for Network Architecture Development of Dominant Carrier Networks,* Decision 95-1-016, 62 CPUC 2nd 575, at 610 (December 6, 1995), adopting as a principle:

> "LRIC studies should be "forward-looking;" i.e., they should not reflect a company's embedded base of facilities. Rather the study should account for only the most efficient and cost-effective means of providing the service."

footnote continued on next page

After the 1996 legislation, this Court required NARUC's member State commissions to set prices in arbitrations under 47 U.S.C. § 252 of the Act in a manner that is not inconsistent with the FCC's stated forward-looking methodology.[13] Even before this Court acted, the State commissions, given the standard set out in § 252, basically followed a forward-looking pricing standard in the arbitrations required under the Act. Indeed, one treatise notes that, even "[w]hile the *Iowa Utilities Board* case was being litigated, most States used their price-setting authority in ways closely following the FCC models." .[14]

---

13 See *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); See also *Iowa Utilities Board, et al v. FCC*, 219 F. 3rd 744, 757 (8th Cir 2000), where the 8th Circuit agrees that the FCC's role is to "resolve general methodological issues," and "it is the State commission's role to exercise its discretion in establishing rates."

14 See Huber, Peter W., Kellogg, Michael K., and Thorne, John, *Federal Telecommunications Law,* § 2.4.4.1, at 185 (2d ed. 1999). During that same period, federal courts consistently rejected arguments that the States' widespread adoption of forward-looking costing methodologies violated the 1996 Act. See, e.g., *GTE South Inc. v. Morrison*, 6 F. Supp. 2d 517, 528-30 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-44, 749 (4th Cir. 1999); see also *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F. Supp. 2d 218, 235-36 (D. Del. 2000). This trend has continued. See, e.g. "Order Granting Southwestern Bell Telephone Company's Petition for Reconsideration of Order on Reconsideration/Clarification Date June 23, 2000" *In the Matter*

footnote continued on next page

A Supreme Court decision upholding ILECs' confiscation claims on the basis of Petitioners' flawed analysis of the statutory text ignores both history and this Court's precedent. It also would have an obvious adverse impact across the range of State and Federal energy, water, and telecommunications utility regulation that has for years relied on forward-looking cost methodologies. As outlined in more detail *infra*, this Court's decisions in *FPC v. Hope Natural Gas Co. ("Hope")*, 320 U.S. 591, 602 (1944), as later affirmed by *Duquesne Light Co. v. Barasch ("Duquesne")*, 488 U.S. 299, 307, 102 L. Ed. 2d 646, 109 S. Ct. 609 (1989), has made modern utility regulation possible by providing regulators with great flexibility to try different methods as long as the overall process and outcome are reasonable. Petitioners have provided no reason for this Court to undercut that flexibility.

---

of the Joint Application of Sprint Communications Company L.P. et al. for the Commission to Open a Generic Proceeding on Southwestern Bell Telephone Company's Rates for Interconnection, Unbundled Elements, Transport and Termination, and Resale, Docket No. 97-SCCC-149-GIT (July 27, 2000), Slip Opinion at page 4, where the Kansas Corporation notes it has ". . .consistently applied TELRIC principles" which it believes best estimates "the costs a forward-looking, efficient competitor would incur." That decision can be downloaded from http://www.kcc.state.ks.us/.

B. PETITIONERS' TAKING ARGUMENTS ARE PREMATURE.

Where a party alleges a governmental taking of its property, but that property has not been taken and, depending on a complex series of future governmental actions (e.g., rate design) may never be taken, the case is not ripe for judicial review.[15] The Petitioners contend that the Fifth Amendment requires that the rates set by the FCC for regulated services be designed to generate future revenues that will, in the aggregate, cover incumbents' prudent historic costs for all regulated services.[16] They do not, however, demonstrate that aggregated revenues *from wholesale services and interstate access charges* fail to cover total prudent costs allocable to those services. Indeed, there is nothing in the record presented for review sufficient to support a claim either that

---

15 See, e.g., *Long Island Lighting Co v. Cuomo*, 666 F. Supp. 370 (N.D.N.Y. 1987). Under traditional "takings" jurisprudence, the Court must engage in "essentially ad hoc, factual inquiries" that address, e.g., the specific economic impact of the regulation; and the extent to which the regulation has interfered with investor-backed expectations. *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). "A court cannot determine whether a regulation has gone 'too far' unless it knows how far the regulation goes." *MacDonald, Sommer & Frates v. Yolo County*, 477 U.S. 340, 348 (1986).

16 ILEC Brief at 17-19. The States do not agree that companies are entitled to rates that necessarily cover all costs (see discussion, *infra*). We do, however, concur with the observation that the FCC cannot look to intrastate revenues to meet the constitutional standard for "just and reasonable" interstate rates. See generally *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930).

Petitioners will fail to receive a return on prudent investment or that there will be significant stranded costs.[17] Petitioners urge this Court to ignore the absence of record evidence solely on the basis of untested extra record assertions that TELRIC will inevitably result in massive discounts from historical costs.

---

17 Other than limited excerpts from Petitioners' personnel, the only "evidence" referenced are extra record statements that the ILEC's network is worth $342 billion, and that TELRIC's valuation of $180 billion is low. ILEC Br. at 10-11. But the $342 billion cited is the *undepreciated* cost. Based on the same data set, net of depreciation, the "value" of the incumbents network is $166 billion. *See* 1999 Statistics of Communications Common Carriers, at Table 2.9 (Account 350) (rel. Aug. 11, 2000), URL: http://www.fcc.gov/bureaus/common-carrier/reports/fccstate_link/socc/99s0cc.pdf. Moreover, that depreciated $166 billion is strictly an embedded or historical cost figure. It does not reflect any review of the "prudence" of costs incurred. See note 4, *supra*.

Inasmuch as further factual development is required before one can even pass judgment on the Petitioners' alleged standard for confiscation, the Petitioners' claim that TELRIC rates result in a taking of their property is speculative and, therefore, premature.[18]

---

18 Indeed, there is public data indicating that the FCC's forward-looking methodology has not resulted in financial losses for ILECs. In a review of a treatise on ILEC takings issues, Professor Trebing observes

> "If investors perceive that the confiscation of assets is taking place, this will be reflected in the {ILEC} stock prices. . .Such an examination reveals no across-the-board price decline . . .On the contrary, stock prices have moved significantly higher over the past decade demonstrating general investor confidence."

Trebing notes the traditional regulatory criterion for judging a reasonable level of profit was a market-to-book ratio of 1.05-1.10. Between 1969-1978, AT&T's M/B ratio was 1.05. (The most recent M/B ratios cited for ILECs show in June 1999 GTE with an M/B of 6.91, Ameritech - 6.34, Bell Atlantic - 7.14, BellSouth - 6.40, and SBC - 6.97). AT&T shows an M/B of 3.95 for the same period. Trebing says: "Whether these increases are attributable to the prospect of oligopoly profits . . .can be debated, *but they do not reflect the burden of stranded and uncompensated costs on the performance of the firm*." Trebing, Harry, *Review of "Deregulatory Takings and the Regulatory Contract", Telecommunications Policy*, 24 (Pergamon 2000) at 161-7. {Emphasis Added.} *Compare*, Gabel & Rosenblum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Com. L.J. 239, 265 (March 2000), where after reviewing financial data from 150 of the largest U.S. phone

footnote continued on next page

C. PETITIONER'S CONSTITUTIONAL ARGUMENTS MISCONSTRUE EXISTING SUPREME COURT PRECEDENT.

The Constitution prohibits government from taking a citizen's property without rendering just compensation. *Regan v. Farmer's Loan and Trust Co.*, 154 U.S. 362 (1894). Regulation, of course, impedes the use of a company's property, but it is permissible, provided the company is paid "just and reasonable" rates for its service to the public. *Munn v. Illinois*, 94 U.S. 113, 126 (1877).

The constitutional floor for the "just and reasonable" standard has undergone several Supreme Court revisions. In 1894, the Court enunciated the "used and useful" doctrine, holding utilities were entitled, as a constitutional minimum, to a reasonable return on the "fair value" of property devoted to the public service; that is, "used and useful" plant.[19] This doctrine touched off decades of controversy over how

companies, the authors conclude the majority surveyed are earning returns that are "more than sufficient" to assure the financial integrity of their enterprises, maintain credit-worthiness and attract additional capital: "Based on this data . .the {ILEC's}. .contention, that the use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports." While NARUC in no way suggests intrastate rates could be called on to offset any interstate revenue deficiency, a telephone utility with robust company-wide earnings should not be heard to allege confiscation.

19 *Smyth v. Ames*, 169 U.S. 466 (1898). "Fair value" was to be determined by a reference to a variety of factors, including the plant's original cost and its reproduction cost. *Id.* at 546, 547.

utilities' facilities should be valued and gave birth to a wide range of ratemaking methods designed to satisfy the "just and reasonable" standard. In 1923, Justice Brandeis suggested the focus belonged not on whether utility plant was useful, but on whether the investments made to construct such plant were prudent. *Missouri ex rel Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (concurring opinion). His position became known as the "prudent investment" rule, which, with the "used and useful" doctrine and other methodologies, fueled the valuation debate for the next two decades. Finally, in 1944, the Supreme Court rendered the discussion academic when it found that regulatory agencies were not bound to use any particular method in determining either the components or the value of a utility's rate base. As the Court indicated, the Constitution offered no basis for overturning an agency's ratemaking method, if the "end result" of the Commission's action was "just and reasonable" rates. *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Specifically, the Court declared that, for purposes of reviewing takings claims under the 5th Amendment, "it is the *result reached* not the method employed which is controlling," and that "[i]f *the total effect of the rate order* cannot be said to be unreasonable, judicial inquiry ... is at an end. *The fact that the method employed to reach that result may contain infirmities is not then important.*"[20]

20 *Id.* at 602 (emphasis added). See also, *In re: Permian Basin Area Rate Cases*, 390 U.S. 747, 791 (1968), approving setting rates based

footnote continued on next page

The Fifth Amendment protects utilities only from regulations that are "so unjust as to be confiscatory."[21] It does not confer a constitutional right to government-subsidized profits. In *Duquesne,* this Court reaffirmed that ". . . it is not the theory but the impact of the rate order which counts." *Id.* at 310. It is not enough that a party merely speculates that a government action will cause it harm; rather, a taking must "'necessarily' result from the regulatory

---

on the *average* costs of a large number of producers, which by definition could not specifically address investor interests in the capital costs of individual producers. The Court pointed out that the investor interests set forth in *Hope* remain pertinent, but "scarcely exhaust the relevant considerations."

21 *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989). According to the ILECs, *Duquesne* says when a regulator switches ratemaking methods, it must ensure the new method continues to provide compensation 'with in the constitutional range of reasonableness' as measured under the old methodology and essentially forecloses a switch in the circumstances presented. ILEC Brief at 26-28. But they misconstrue the opinion. In dicta, *Duquesne* did suggest that an agency that arbitrarily switched back and forth between methodologies in a way that required investors to bear the risk of bad investments some times while denying them the benefit of good investments at others could raise constitutional questions. *Duquesne* at 315. But that clearly is not the case presented. Indeed, *Duquesne* specifically recognizes that, "circumstances may favor the use of one ratemaking procedure over another." *Duquesne* at 316. Nor does Justice Scalia's concurrence support ILEC's position. It too confirms that the consequence of regulation, not the technique used, is the critical consideration for determining if a takings claim can be asserted. This undercuts the ILECs' appeal as it is clear they are merely challenging the FCC adoption of a forward-looking methodology, rather than the actual consequences of the use of that "technique."

actions." [22]

The *Hope* "end result" test should also be read in conjunction with this Court's subsequent decision in *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942). In *Natural Gas Pipeline*, the Court held that:

> "[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has

---

22 See, *United States v. Riverside Bayview Homes*, 474 U.S. 121, 128 n.5, (1985). Compare, *Alenco Communications, Inc., et al. v. FCC*, 201 F.3d 608, 624 (5th Cir. 2000), where the 5th Circuit found rural LECs challenging FCC universal service orders failed to show a taking because they relied on mere speculation to support their claims, explaining:

> "petitioners must wait to experience the actual consequences of the Order before a court may even begin to consider whether the FCC has effected a constitutional taking. Until it is known what level of universal service funding each petitioner will receive . . . and under what circumstances the Commission will grant a waiver, we cannot seriously entertain a Takings Clause challenge."

> been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances." 315 U.S. at 586.

Moreover, the Court held that

> "regulation does not insure that the business shall produce net revenues, nor does the Constitution require that the losses of the business in one year shall be restored from future earnings by the device of capitalizing the losses and adding them to the rate base on which a fair return and depreciation allowance is to be earned ... the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated, business." 315 U.S. at 590.

In concurring with the majority opinion, Justices Black, Douglas and Murphy added that they saw no reason why agency ratemaking should be subject to any constitutional floor.[23] Justices Black, Douglas and Murphy would have limited Supreme Court review to whether the agency's decision that rates were "just and reasonable" was supported in the record. 315 U.S. at 604-607. In deciding that issue, they emphasized that

> "a return to the company of the cost of the service might not be 'just and reasonable' to the public ... [t]he investor and consumer interests may so collide as to warrant the rate-making body concluding that a return on historical cost or prudent investment, though fair to investors, would be grossly unfair to the consumers." 315 U.S. at 607, 608.

---

23 "[W]e must record our disagreement from an opinion which, although upholding the action of the Commission on these particular facts, nevertheless gives renewed vitality to a 'constitutional' doctrine which we are convinced has no support in the Constitution" 315 U.S. at 601.

In any event, the constitutional rate floor applied by the majority opinion in *Natural Gas Pipeline* included a proviso that consumer interests may preclude the recovery of prudent costs.[24]

With regard to whether rates are "just and reasonable," *Hope* concluded that rates must involve "a balancing of the investor and the consumer interests," but companies are not assured rates that cover all costs. 320 U.S. at 603.

---

24 As noted in the concurring opinion, this principle was first "announced by this Court in *Covington & Lexington Turnpike Co. v. Sandford*, 164 U.S. 578: '[i]t cannot be said that a corporation is entitled, as of right, and without reference to the interests of the public, to realize a given per cent upon its capital stock ... [t]he public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends'." 315 U.S. at 607, 608.

Thus, the "end result" test of Hope does not guarantee utilities either a particular ratemaking method[25] or recovery of all costs.[26] Rather, it reaffirms that regulators must balance ratepayer and shareholder interests.[27]

Since *Hope*, the courts have made it abundantly clear that utilities have no constitutional claim to rates based on any particular ratemaking method, or to the recovery of historic costs. *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *NEPCO Municipal Rate Committee v. Federal Energy Regulatory Comm'n*, 668 F.2d 1327 (1981).[28]

---

25 "[I]t is the result reached not the method employed which is controlling" (320 U.S. at 602).

26 "[W]e stated in the *Natural Gas Pipeline Co.* case that 'regulation does not insure that the business shall produce net revenues'" (320 U.S. at 603 [quoting 315 U.S. p. 590]).

27 In *Hope*, the Circuit Court of Appeals had attempted to limit the holding in *Natural Gas Pipeline* that there was no constitutional requirement "that the owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it" to businesses scheduled to end on a day certain, as was the case in *Natural Gas Pipeline*. The Supreme Court rejected the Circuit Court's reasoning, noting that "that distinction is quite immaterial." 320 U.S. at 606.

28 In *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court upheld the constitutionality of a State statute prohibiting the recovery of expenditures for generating facilities that were not "used and useful" in the public service. Duquesne adds further support to the long-standing principle that it is the "end result" of ratemaking that is subject to scrutiny, not whether rates recover particular (e.g., historic) costs.

Accordingly, Petitioners' contention that the FCC's rules take the incumbents' property by raising the possibility of their being unable to recover historic costs is simply incorrect.

Moreover, as discussed *supra*, to succeed in its takings claim, the ILECs must demonstrate that the FCC's adoption of a forward-looking methodology will "jeopardize" their "financial integrity," either by "leaving them insufficient operating capital or by impeding their ability to raise future capital," or demonstrate that the funds provided "are inadequate to compensate current equity holders for the risk associated with their investments." *Duquesne*, 488 U.S. at 312. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and the constitutional review of the rate order is at an end.[29]

Petitioners essentially claim the FCC's adoption of the TELRIC methodology is constitutionally impermissible because the agency has not determined in advance if the rates produced will result in revenues the ILECs deem to be sufficient.

---

29 Compare, *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 at 1181 n.3 (D.C. Cir. 1987).

Aside from (1) the somewhat questionable thesis that TELRIC "necessarily falls short of providing recovery of incumbents' historical costs,"[30] and (2) the inaccurate implicit assumption that utility investors are constitutionally guaranteed recovery of specific items of cost or investment, rather than overall rates set at just and reasonable levels, the ILECs have not presented any compelling evidence that demonstrates the rates produced by the FCC's use of this forward-looking methodology actually jeopardizes the financial integrity of the company.

Absent a showing by ILECs that the FCC's Order has produced overall rates that result in financial harm, Petitioners have not even met the threshold test for establishing a takings claim under prevailing Supreme Court precedent and its confiscation claims must be rejected.

---

30 Certainly if history is any guide, forward-looking costing methodologies do not always produces costs lower than historic costs. See, e.g., *First Order*, 12 F.C.C. Rcd 8776, 8901 at ¶ 228 (observing that historic costs can be higher or lower than forward-looking costs). Indeed, the FCC points out in a recent order, that the most recent model incorporating a forward-looking costing methodology generates costs from some areas that exceed the incumbent local exchange carriers' book costs. *In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 FCC Rcd 20156, at ¶ 26, (Nov. 2, 1999) See also, *Hope*, 320 U.S. at 596-7 (forward-looking costs higher than historic costs); *Southwestern Bell Telephone Co. v. Public Serv. Comm'n of Mo.*, 262 U.S 276, 299-300 (1923). (Brandeis, J. concurring) (noting in some cases "replacement costs" are much greater than the actual cost of installation).

CONCLUSION

For the reasons set forth, *supra*, Respondents urge the Court to reject ILECs' arguments that the use of a forward-looking methodology necessarily results in an uncompensated taking under the 5th amendment.

Respectfully submitted,

LAWRENCE G. MALONE
General Counsel
PUBLIC SERVICE COMMISSION
OF THE STATE OF NEW YORK
THREE EMPIRE STATE PLAZA
ALBANY, NY 12223-1350
(518) 474-2510

JAMES BRADFORD RAMSAY*
General Counsel
SHARLA BARKLIND
Assistant General Counsel
NATIONAL ASSOCIATION OF
REGULATORY UTILITY
COMMISSIONERS
1101 VERMONT AVE, NW, #200
WASHINGTON, DC
(202) 898-2207

August 6, 2001

* Counsel of Record

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
JUL 8 2001
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Respondents.

JUL 8 2001

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF ON THE MERITS OF SPRINT CORPORATION IN OPPOSITION TO PETITIONERS VERIZON COMMUNICATIONS, INC., *ET AL.*

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

RULE 29.6 STATEMENT

In accordance with Rule 29.6 of the Rules of this Court, Sprint Corporation ("Sprint") states as follows:

Sprint is a corporation organized for the purpose of engaging in telecommunications and related businesses and is publicly traded under the names Sprint FON and Sprint PCS. Sprint Communications Company L.P. is a wholly-owned subsidiary of Sprint.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
RULE 29.6 STATEMENT	ii
TABLE OF AUTHORITIES	v
PRELIMINARY STATEMENT	1
STATEMENT OF THE CASE	1
A. Background	1
B. The Act	2
C. The FCC's *Local Competition Order*	4
D. Judicial Review of the *Local Competition Order*	9
1. The First Eighth Circuit Decision	9
2. *IUB I*	9
3. The Eighth Circuit's Decision On Remand (*"IUB II"*)	10
SUMMARY OF ARGUMENT	11
ARGUMENT	14
I. NOTHING IN THE ACT REQUIRES INCORPORATION OF AN ILEC's HISTORICAL COSTS INTO THE RATES FOR UNEs	14
A. Section 252(d)(1) Is Ambiguous And Does Not Require The Use Of Historical Costs In Establishing UNE Rates	14
B. Other Provisions Of The Act Do Not Compel The Use Of Historical Costs For UNE Pricing	19

TABLE OF CONTENTS—Continued

	Page
1. The Act Expresses No Preference For Historical Cost Models And There Is No Reason To Infer One	19
2. The Act's Resale Pricing Provision Does Not Implicitly Endorse Historical Or Forward-Looking Cost Models	22
C. The FCC's Choice Of A Forward-Looking Cost Methodology Was Not Arbitrary Or Capricious And Is Entitled To Deference	23
1. Historical Costs Are Antithetical To The Act's Objectives	24
2. TELRIC Is Not "Unmanageable"	25
3. The FCC Did Not "Abandon" Historical Cost Models	26
II. THE FCC's SELECTION OF THE TELRIC METHODOLOGY DOES NOT VIOLATE THE TAKINGS CLAUSE	27
A. TELRIC Does Not Represent A Constitutionally Suspect Shift In Methodologies	27
B. The ILECs' Theoretical Attacks On TELRIC Are Barred By The Well-Settled "Total Effect" Test For Regulatory Takings	33
C. The Doctrine Of Constitutional Avoidance Does Not Require The Inclusion Of Historical Costs In UNE Prices	38
CONCLUSION	41

TABLE OF AUTHORITIES

CASES	Page
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
American Public Gas Ass'n v. Federal Power Comm'n, 567 F.2d 1016 (D.C. Cir. 1977)	20
American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry., 387 U.S. 397 (1967)	30
Apex Plumbing Supply, Inc. v. U.S. Supply Co., 142 F.3d 188 (4th Cir. 1998)	18
Appalachian Power Co. v. EPA, 135 F.3d 791 (D.C. Cir. 1998)	15
Baltimore & Ohio R.R. v. United States, 345 U.S. 146 (1953)	35
Bell Atl. Tel. Cos. v. FCC, 24 F.3d 1441 (D.C. Cir. 1994)	39
Brooks-Scanlon Co. v. Railroad Comm'n of La., 251 U.S. 396 (1920)	33, 35
Burlington N. R.R. v. Surface Transp. Bd., 114 F.3d 206 (D.C. Cir. 1997)	18
Capital Network Sys., Inc. v. FCC, 28 F.3d 201 (D.C. Cir. 1994)	15, 16
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	11, 23
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	*passim*
Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944)	*passim*
GTE S., Inc. v. Morrison, 6 F. Supp. 2d 517 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999)	19, 21, 22
Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993)	17, 32

TABLE OF AUTHORITIES—Continued

	Page
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	4, 6, 9
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	*passim*
Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987)	37
Market St. Ry. v. Railroad Comm'n of Cal., 324 U.S. 548 (1945)	29, 30, 31
Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276 (1923)	16
Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos., 498 U.S. 211 (1991)	16
National Rural Telecom Ass'n v. FCC, 988 F.2d 174 (D.C. Cir. 1993)	22, 31
New York Cent. R.R. v. White, 243 U.S. 188 (1917)	30
In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	31, 36
Railway Labor Executives' Ass'n v. United States, 987 F.2d 806 (D.C. Cir. 1993)	39
Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc., No. A 97-CA-132 SS, 1998 WL 657717 (W.D. Tex. Aug. 31, 1998)	*passim*
Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118 (1939)	28, 30
Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000)	20, 41

TABLE OF AUTHORITIES—Continued

	Page
Town of Concord v. Boston Edison Co., 915 F.2d 17 (1st Cir. 1990)	24
United States v. Miller, 317 U.S. 369 (1943)	30
United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985)	13, 39
In re Valuation Proceedings Under §§ 303(c) & 306 of the Reg'l Rail Reorg. Act, 439 F. Supp. 1351 (Regional Rail Reorg. Ct. 1977)	35, 36
Williamson County Reg'l Planning Comm'n v. Hamilton Bank, 473 U.S. 172 (1985)	38, 40
AGENCY DECISIONS	
Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in Mich., 12 F.C.C.R. 20,543 (1997)	4
In re Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996)	*passim*
Policy and Rules Concerning Rates for Dominant Carriers, 5 F.C.C.R. 6786 (1990)	21
STATUTES	
47 U.S.C. § 201(b)	4
47 U.S.C. § 251(c)(2)	2
47 U.S.C. § 251(c)(3)	3
47 U.S.C. § 251(c)(4)	3
47 U.S.C. § 251(d)(1)	4, 19
47 U.S.C. § 252(b)(4)	21
47 U.S.C. § 252(d)(1)	*passim*
47 U.S.C. § 252(d)(1)(A)(i)	3
47 U.S.C. § 252(d)(1)(B)	3

TABLE OF AUTHORITIES—Continued

	Page
47 U.S.C. § 252(d)(3)	22, 23
47 U.S.C. § 252(e)(6)	38
47 U.S.C. § 254	26, 37
RULES	
47 C.F.R. § 51.505(b)(1) (2000)	2, 6
47 C.F.R. § 51.505(b)(2) (2000)	6
47 C.F.R. § 51.505(b)(3) (2000)	7
47 C.F.R. § 51.505(c) (2000)	7
CONGRESSIONAL MATERIAL	
S. Conf. Rep. No. 104-230 (1996)	2
OTHER AUTHORITIES	
Edwin Mansfield, *Microeconomics* (6th ed. 1988)	19
Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* (3d ed. 1994)	16
Laurence H. Tribe, *American Constitutional Law* (2d ed. 1988)	36
Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (1st ed. 1992)	22
Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (2d ed. 1999)	26
Reed E. Hundt, *You Say You Want A Revolution* (2000)	5
Webster's New World Thesaurus (new rev. ed. 1985)	16

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.2 and 25.1, Sprint Corporation ("Sprint") respectfully submits this Respondent's Brief on the Merits in Opposition to Petitioners Verizon Communications, Inc., *et al.* addressing the following question:

> Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 ("Act") requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

Supreme Court Order List (Jan. 22, 2001) at 4.

STATEMENT OF THE CASE

A. Background

Unlike many of the private parties in these proceedings, Sprint has substantial local *and* long distance operations. Sprint has participated both as a new entrant and as an incumbent local exchange carrier ("ILEC") in state-regulated arbitrations pursuant to Section 252 of the Act. These experiences have given Sprint a balanced perspective on the challenges of opening local telephone markets to competition while satisfying the divergent interests of new entrants and ILECs. The "long distance side" of Sprint, like other new entrants, is interested in obtaining access to unbundled network elements ("network elements" or "UNEs") of ILECs at rates and on terms that permit meaningful local competition. The "local side" of Sprint, like other ILECs, is interested in ensuring that it receives just and reasonable compensation for providing UNEs to new entrants.

Sprint believes that the UNE pricing methodology adopted by the Federal Communications Commission ("FCC") strikes the proper balance in implementing the Act's pro-competitive objectives. The FCC established a forward-looking, long-run

methodology for pricing UNEs based on "the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers." JA 51.[1] This methodology, which is known generally as "Total Element Long Run Incremental Cost" or "TELRIC," attempts to replicate prices that would prevail in a competitive environment, while ensuring that the ILEC is justly compensated for the use of its network elements at prices reflecting what it would cost to replace the functionalities provided by those elements today.

B. The Act

The Act seeks to transform state-sanctioned local monopolies into fully competitive markets on a national scale. *See* S. Conf. Rep. No. 104-230, at 113 (1996) (the primary goal of the Act is to increase competition in both local and long distance telephone markets as swiftly as possible). Congress recognized the practical and economic impediments that new entrants would face if forced to replicate all of the ILEC's existing local network infrastructure. Congress thus established comprehensive requirements "intended to facilitate market entry." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999) ("*IUB I*"). "Foremost" among them is the ILEC's "obligation under [the Act] to share its network with competitors." *Id.*

Section 251(c) provides three complementary avenues for new entrants to obtain access to an ILEC's network. First, a new entrant may "interconnect" its facilities with an ILEC's existing local network. JA 12-13. This enables the new entrant to transmit and receive calls to and from all local telephone subscribers without replicating an entire telephone network.

---

[1] The Court has agreed to the submission of a deferred Joint Appendix ("JA").

Second, a new entrant may purchase an ILEC's retail services at wholesale rates and then resell the services to local customers under the new entrant's brand name. JA 13. This enables the new entrant to compete on the basis of price and service, without investing in any of its own facilities.

Third, and most relevant here, a new entrant may lease UNEs from the ILEC. *Id.* New entrants may use the leased UNEs, alone or in combination with the new entrant's own network facilities, to offer new and different competitive services. ILECs are to receive "just [and] reasonable" compensation for leasing UNEs, "based on the cost . . . of providing" the element, including a "reasonable profit." JA 13, 23.

Contrary to the ILECs' assertions, the Act expresses no preference for "facilities-based competition" among these three alternatives. This Court—and the Eighth Circuit—have already rejected that notion. In upholding the FCC's so-called "all elements" rule, which allows competitors to provide local telephone service relying solely on leased UNEs, this Court held that:

> [T]he [FCC] reasonably omitted a facilities-ownership requirement. The 1996 Act imposes no such limitation; if anything, it suggests the opposite, by requiring in § 251(c)(3) that incumbents provide access to "any" requesting carrier. We agree with the [Eighth Circuit] that the [FCC's] refusal to impose a facilities-ownership requirement was proper.

IUB I, 525 U.S. at 392-93. The Eighth Circuit similarly held that:

> [A]fter study, we do not believe that the Act's exclusive goal is facilities-based competition. While Congress may have envisioned facilities-based competition in local telephone markets to occur down the road, Congress clearly included measures in the Act, such as the interconnection, unbundled access, and resale provisions, in order to expedite the introduction of

> pervasive competition into the local telecommunications industry. Congress recognized that the amount of time and capital investment involved in the construction of a complete local stand-beside telecommunications network are substantial barriers to entry, and thus required incumbent LECs to allow competing carriers to use their networks in order to hasten the influence of competitive forces in the local telephone business.

Iowa Utils. Bd. v. FCC, 120 F.3d 753, 816 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). *Cf.* JA 271-272 (¶ 12) ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.").[2]

C. The FCC's *Local Competition Order*

Congress expressly authorized the FCC to promulgate rules implementing the Act's pro-competitive requirements and set few limits on the agency's exercise of that authority. JA 10, 14. As this Court has recognized, the key provisions of the Act are subject to multiple interpretations and Congress was "well aware" that these ambiguities would be resolved by the FCC. *IUB I*, 525 U.S. at 397.[3]

---

[2] The ILECs' contention that Congress valued facilities-based competition over UNE-based competition is also disingenuous. For example, SBC, BellSouth, and Ameritech successfully argued to the FCC that UNE-based competition is the equivalent of facilities-based competition for purposes of meeting the requirements of Section 271(c)(1)(A) ("Presence of a Facilities-Based Competitor") of the Act, which prohibits Bell Operating Companies from offering long distance services in the areas in which they are the incumbent until they have proven that those local markets are effectively open to competition. *Application of Ameritech Mich. Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Servs. in Mich.*, 12 F.C.C.R. 20,543, 20,590-91 (¶¶ 86-87) (1997).

[3] The ILECs use statements from former FCC Chairman Reed Hundt to assert that the FCC "was dissatisfied with the 1996 Act" and purposely discriminated against the ILECs in favor of new entrants. These *post*-employment statements are irrelevant; they have also been misleadingly selected and quoted out of context. In the same passages cited by the ILECs, the former Chairman emphasized that the FCC "did not want to confer advantage on particular companies." Reed E. Hundt, *You Say You Want A Revolution* 155 (2000). He also noted that the Act produced "a mountain of ambiguity" and that subsequent regulations interpreting these ambiguities may allow new entrants a "fairer chance to compete," consistent with Congress' goal of opening the local telephone market to competition. *See id.* at 154.

Virtually the entire telecommunications industry participated in the FCC's rulemaking proceedings, which culminated in the *Local Competition Order*. A significant part of these efforts focused on the appropriate compensation that new entrants should pay to lease UNEs from ILECs. Most ILECs favored a pricing methodology that would allow recovery of the "historical costs" of their network elements. JA 359-361 (¶ 655). Most new entrants argued that a forward-looking methodology was necessary to allow competition to develop. JA 340-342 (¶ 635).

The FCC carefully evaluated the various cost methodologies proposed by the commenters, JA 325-423 (¶¶ 618-740), and ultimately determined that TELRIC was the most effective and fair means to implement the Act's pro-competitive goals, JA 379-380 (¶ 679). Based on substantial economic commentary and analysis, the FCC concluded that a forward-looking cost methodology, such as TELRIC, would best replicate the conditions of a competitive market. JA 379-380, 398-399 (¶¶ 679, 705). Typically, new firms enter a market and set prices based on the costs of building the most efficient facilities necessary to compete. Incumbents must then respond to those prices, even if their existing facilities are less efficient. JA 379-380 (¶ 679). Forward-looking pricing of UNEs helps to achieve a similar result. New entrants cannot immediately compete on equal terms because the costs of entry (*viz.*, replicating a ubiquitous local network)

are vastly too prohibitive to be incurred all at once. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 816. A methodology based on forward-looking economic costs helps to "drive retail prices to their competitive levels" by setting costs at levels firms would face in a competitive market. JA 380 (¶ 679). This, in turn, "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." JA 333 (¶ 630).

The FCC also took steps to ensure that the TELRIC methodology allows ILECs to recover the full forward-looking cost of leased UNEs, by measuring the long-run, incremental cost of the network element based on: (i) the use of the "most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers," JA 51; (ii) the cost of capital, thus allowing ILECs to recover normal economic profit, *id.* and (iii) the useful life of the element, as measured by its economic depreciation rate, *id.* In addition, TELRIC allows for a reasonable share of joint and common costs. JA 51-52.

The FCC concluded that TELRIC would not always result in forward-looking costs that are below historical costs. Although the application of TELRIC to certain elements of an ILEC's local telephone network, such as switches and other computer-based components, may result in forward-looking costs below historical costs, the opposite may be true for other elements such as loops, whose costs are driven by material or labor. JA 398-399, 400-401 (¶¶ 705, 707). At the same time, the FCC determined that an ILEC's existing wire centers should be used as a component of TELRIC, precisely to "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, [would be] able to provide the service at a lower cost than the incumbent LEC." JA 384 (¶ 685).

The FCC considered and addressed each of the objections to TELRIC raised by the ILECs. By designing a forward-looking cost methodology that simulates a competitive market, the FCC sought to ensure that the rates eventually produced by TELRIC are properly balanced and enable new entrants to compete for local customers from the outset. JA 383-384 (¶ 685). On the one hand, if UNE rates are set below forward-looking costs, new entrants might be deterred from building competing facilities. Moreover, some new entrants might be induced to enter using network elements where it would not otherwise be economically efficient for them to do so. On the other hand, if UNE rates are set too high, which a methodology based on historical or "embedded" costs might produce, competitive entry may never occur. Because the costs of immediately building a completely ubiquitous local network would be prohibitive for any one firm, most new entrants must rely in part on leased UNEs to provide a full range of local services. Excessive UNE rates would make it impossible for new entrants to price these services at competitive levels, effectively impeding market entry.[4]

---

[4] The ILECs claim that TELRIC pricing has caused "many entrants" to alter plans "away from deploying competing facilities." Brief for Petitioners ("Pet'r Br.") at 13, 49. This claim is rebutted by FCC data indicating that no single method of competitive entry predominates. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001). The isolated examples they cite to from 1996 fail to demonstrate that TELRIC caused "many new entrants" to halt facilities-based entry. At that time, the FCC's pricing rules were vacated and the individual state commissions were in the process of determining UNE pricing in individual arbitrations. Moreover, a myriad of reasons may explain why a particular company would modify a business strategy away from expending the massive amounts of capital needed for facilities-based entry. For example, a particular new entrant may have difficulty in raising the needed capital. *See* Letter from Chairman Michael Powell to Congress of 5/4/01, at 1. A new entrant may also reasonably wait to invest in facilities until it has reached sufficient

The FCC similarly rejected the ILECs' argument that forward-looking costs should be based exclusively on an ILEC's existing network, without regard to available, more efficient substitutes. JA 383 (¶ 684). Because this approach would allow ILECs to recover costs "that reflect inefficient or obsolete network design and technology," the FCC found it would be "essentially an embedded cost methodology." *Id.* A forward-looking methodology, in contrast, rationally examines what it would cost to replace the functions that make a network asset valuable. This includes currently available substitutes that perform the same functions as the original network element, but embody more efficient technologies to do so. JA 382-384 (¶¶ 683-685).[5]

The FCC also found that a forward-looking cost methodology would not result in a "taking" of the ILECs' property without just compensation. Under this Court's precedents, the "just and reasonable" standard of the Takings Clause requires, in the regulatory context, an examination of the "total effect" of the actual rates established by the agency. JA 419-421 (¶¶ 734-737). After reviewing the record, the FCC found that "[n]o incumbent LEC has provided persuasive evidence that prices based on a forward-looking

---

scale by servicing customers through resale and UNEs, which in many parts of the country new entrants have failed to reach even today, five years after the Act's passage.

[5] The ILECs claim that TELRIC "hypothesizes a fantasy world in which carriers would repeatedly rip out and instantaneously rebuild their entire plant every time a newer technology hits the market or a more efficient configuration could be achieved." Pet'r Br. at 9-10. This assertion is exaggerated. TELRIC rationally measures the cost of providing the actual network element by asking what cost the ILEC or any other carrier would bear in the marketplace, *at the time the UNE rates are established*, to replace the functions of the network element at issue with currently available efficient substitutes consistent with the ILEC's existing wire center. UNE rates are typically in place for the term of an interconnection agreement, which is commonly three to four years, and are not changed "every time a newer technology hits the market."

economic cost methodology would have a significant impact on its 'financial integrity.'" JA 422 (¶ 738). Even so, the FCC specifically ordered the ILECs to "seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* (¶ 739). The FCC also determined that TELRIC is consistent with the "just and reasonable" standard used for takings that result in a physical occupation of property. JA 422-423 (¶ 740).

Finally, the FCC determined that state commissions would be able to implement TELRIC in setting UNE rates. A number of state commissions were already using forward-looking methodologies similar to TELRIC in setting retail rates for local services. JA 334-336, 381 (¶¶ 631, 681). As the FCC found, "the record demonstrates that such approaches are practical and implementable." JA 381 (¶ 681).

D. Judicial Review of the *Local Competition Order*

1. The First Eighth Circuit Decision

Challenges to the *Local Competition Order* were consolidated in the Eighth Circuit and first decided in 1997. Among other things, the Eighth Circuit invalidated the FCC's pricing rules—including TELRIC—holding that the Act gives state public utility commissions, not the FCC, general jurisdiction to interpret and implement the Act's pricing provisions. *Iowa Utils. Bd. v. FCC*, 120 F.3d at 794.

2. *IUB I*

On review, this Court held, *inter alia*, that Section 201(b) of the Act gives the FCC jurisdiction to adopt rules to implement all of the Act's local competition provisions. *IUB I*, 525 U.S. at 377-86. The Court reversed the Eighth Circuit's ruling that the FCC lacked the statutory authority to establish national pricing rules, reinstated the FCC's pricing rules, and remanded so that the Eighth Circuit could review the substantive challenges to them. *Id.* at 377-78.

3. The Eighth Circuit's Decision On Remand ("*IUB II*")

The Eighth Circuit found that the term "cost" in § 252(d)(1) is "ambiguous" and that the FCC was authorized to interpret the term to allow for a forward-looking cost methodology like TELRIC. *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 751-52 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 11a). The Eighth Circuit further held that the FCC's "use of a forward-looking cost methodology was reasonable . . . [and] that the FCC explained in detail its reason for selecting [such] a methodology to implement the new competitive goals of the Act." *Id.* at 752 (FCC Pet. App. 12a).[6]

The Eighth Circuit also rejected the ILECs' argument that the doctrine of constitutional avoidance required the FCC to use a historical cost methodology. "[A] takings claim," the court correctly noted, "cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *Id.* at 754 (FCC Pet. App. 17a). Accordingly, the Eighth Circuit held that:

> "It is not enough that a party merely speculates that a government action will cause harm." We do not need to disregard *Chevron* deference and interpret the statute in accordance with the petitioners' views in order to avoid an unconstitutional taking in this instance. The possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction. In such circumstances, the adoption of a narrowing construction might frustrate a potentially permissible application of a statute. Because the consequences of the FCC's choice to use TELRIC methodology cannot be known until the resulting rates have been determined and applied, the constitutional claim is not ripe.

Id. at 754 (citations omitted) (FCC Pet. App. 17a-18a).

[6] The Eighth Circuit's vacation of Rule 505(b)(1) is addressed in Sprint's previously-filed Brief on the Merits in Support of Petitioners Federal Communications Commission and United States of America.

SUMMARY OF ARGUMENT

The FCC's choice of the TELRIC methodology is entitled to substantial deference. Under *Chevron*, the agency's decision should be upheld unless "Congress has . . . addressed the precise question at issue" and unambiguously foreclosed the agency's choice or the agency's reasoning was arbitrary. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43, 845 (1984) ("*Chevron*"). The Act, as this Court found, "is in many important respects a model of ambiguity or indeed even self-contradiction" that imposes few restraints on the FCC's exercise of its implementing authority. *See IUB I*, 525 U.S. at 397 (the Act grants "most promiscuous rights" to the FCC). In applying *Chevron* deference to FCC regulations promulgated under the Act, this Court has held that such regulations should be affirmed unless they exceed the few "clear limits" that the Act contains. *Id.*

The Act does not mandate or prohibit any particular pricing methodology for UNEs. As the Eighth Circuit correctly found, "the term 'cost,' as it is used in [Section 252(d)(1)], is ambiguous and . . . Congress has not spoken directly on the meaning of the word in this context." *IUB II*, 219 F.3d at 751 (FCC Pet. App. 11a). The responsibility for interpreting and implementing that provision thus belongs to the FCC, not the courts. *Id.* at 752 (FCC Pet. App. 12a). The FCC evaluated numerous alternatives, including historical and forward-looking cost methodologies, before determining that TELRIC would best serve the dual goals of fairly compensating ILECs for UNEs while promoting the competitive market conditions desired by Congress. JA 325-423 (¶¶ 618-740). The FCC also "explained in detail its reason for selecting a

forward-looking cost methodology to implement the new competitive goals of the Act." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The agency's expert judgment to use TELRIC, rather than a methodology that includes historical costs, was well-reasoned, supported by the record, and should be affirmed.

The ILECs assert that TELRIC is an "unmanageable" methodology and that it was arbitrary and capricious for the FCC to adopt it. This claim is readily disproved. In adopting TELRIC, the FCC found that the methodology was both practical and implementable by the states. These findings have been confirmed by experience, as state commissions around the country have successfully applied TELRIC in establishing UNE rates within the timetables set by the Act. Even after the Eighth Circuit invalidated the FCC's promulgation of TELRIC on jurisdictional grounds, a majority of state commissions adopted the methodology, independently concluding that it best served the goals of fairly compensating ILECs, promoting local competition, and ensuring efficient entry, utilization, and expansion of the telecommunications infrastructure.

The FCC's adoption of the TELRIC methodology does not violate the Fifth Amendment to the United States Constitution. The ILECs wrongly claim that the FCC "shifted" methodologies from a historical to a forward-looking cost methodology and that this "opportunistic switch" results in an uncompensated taking. This argument is based on an analytical artifice that lacks factual and legal foundation. Congress charged the FCC with implementing an entirely new regulatory regime that opens decades-held monopolies to competition. The FCC was not bound by any of the historical and forward-looking cost methodologies used by the agency or the states in establishing rates during the monopoly era. Rather, the FCC was obligated to use its expert judgment in adopting a methodology that both comports with the Act's UNE pricing standards and promotes

the pro-competitive goals of Congress. The FCC's adoption of TELRIC helps to implement the new Act and in no way resembles the type of "opportunistic switch" from a settled cost methodology that might raise constitutional concerns under this Court's precedents.

The ILECs' "takings" challenge to the TELRIC methodology itself also fails. A takings claim must be based on an actual rate, not the ratemaking methodology. "It is not theory but the impact of the rate order which counts." *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("*Hope Natural Gas*"). As the Eighth Circuit found, the ILECs' takings claim remains purely theoretical. The ILECs presented no credible evidence during the FCC rulemaking that TELRIC prices or the Act's overall pricing scheme would significantly affect their financial integrity. Nor have they provided any persuasive evidence of such effects here. Even if a takings challenge to the TELRIC methodology were ripe, it would still fail. The TELRIC methodology allows ILECs to recover their full forward-looking costs of providing UNEs to new entrants. When properly applied, the methodology comports with the Act's requirement that ILECs receive "just and reasonable" compensation for leasing UNEs. The ILECs are entitled to no more.

Finally, the ILECs wrongly argue that the "constitutional avoidance" doctrine negates *Chevron* deference and requires adoption of a historical cost methodology. Mere allegations that a regulatory program may result in a taking does not justify the use of a narrowing construction which might frustrate a potentially permissible application of a statute. *See United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29 (1985) ("*Riverside Bayview Homes*"). The Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates, thus obviating any basis for a limiting construction. The ILECs have not shown that

any actual rates derived from TELRIC are so unjust as to be confiscatory. Their unsubstantiated claims of potential constitutional infirmity provide no basis for this Court to disregard *Chevron* deference in favor of the ILECs' restrictive views of the Act's UNE pricing provisions.

ARGUMENT

I. NOTHING IN THE ACT REQUIRES INCORPORATION OF AN ILEC's HISTORICAL COSTS INTO THE RATES FOR UNEs.

Section 252(d)(1) of the Act requires "just and reasonable" rates for UNEs "based on the cost . . . of providing the . . . network element. . . . and may include a reasonable profit." JA 22-23. The Eighth Circuit properly determined that Section 252(d)(1) is ambiguous as to the cost methodology that may be employed in establishing UNE rates. *IUB II*, 219 F.3d at 751-53 (FCC Pet. App. 10a-14a). The Eighth Circuit thus upheld the FCC's adoption of a forward-looking cost methodology as a reasonable interpretation of the statute. *Id.* at 752-53 (FCC Pet. App. 11a-14a). The ILECs challenge these holdings, arguing that the "plain text, structure, and purpose of Section 252" demonstrate that Congress unambiguously intended for an ILEC's "historical" costs to be included in the UNE rate methodology. Brief for Petitioners ("Pet'r Br.") at 16, 19-21. These arguments are unpersuasive when measured against the statutory language and scheme.

A. Section 252(d)(1) Is Ambiguous And Does Not Require The Use Of Historical Costs In Establishing UNE Rates.

The ILECs' "plain text" argument relies heavily on various dictionary definitions of "cost" that have little relevance to the term's use in the ratemaking context. According to the ILECs, "cost" simply means the amount paid for an item at the time it was purchased or built. *Id.* at 19. They contend, therefore, that the term "cost," as used in Section 252(d)(1)(A)(i), must include all of an ILEC's past expenditures, *i.e.*, "historical" costs. *Id.* The ILECs also rely on the purported use of the term "cost" in the *pre*-Act monopoly era, arguing that "for decades" the telecommunications industry has used the term "cost" to mean "historical" cost and that Congress intended for the term's use in Section 252(d)(1) to be vested with that same meaning. *Id.* at 20.

Contrary to the ILECs' assertions, the term "cost," when used in the regulatory ratemaking context, is susceptible to different meanings and is not confined to a particular dictionary definition. The Act neither defines the term "cost," as used in Section 252(d)(1), nor does it require that UNEs be priced based on any particular cost methodology. As the Eighth Circuit found, "Congress has *not* spoken directly on the meaning of the word in this context. . . . '[T]he word "cost" is a chameleon, capable of taking on different meanings, and shades of meaning, depending on the subject matter and the circumstances of each particular usage.'" *IUB II*, 219 F.3d at 751-52 (emphasis added) (quoting *Strickland v. Commissioner, Maine Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir. 1995)) ("the word 'cost' is a chameleon") (FCC Pet. App. 11a); *see Appalachian Power Co. v. EPA*, 135 F.3d 791, 809 (D.C. Cir. 1998) (noting "essential ambiguity of the word"). Such an ambiguous term confers, in the words of Justice Breyer, "'broad methodological leeway,'" and "say[s] little about the 'method employed' to determine a particular rate." *IUB I*, 525 U.S. at 423 (citation omitted). The FCC, therefore, properly exercised its authority in interpreting the term to permit a forward-looking cost methodology for establishing UNE rates. *See id.* at 397.[7]

---

[7] Similarly, the Act's "just and reasonable" pricing provisions are the type of "ambiguous statutory terms" that require "substantial deference to the interpretation the [FCC] accords them." *Capital Network Sys., Inc. v.*

Moreover, Section 252(d)(1) refers to the "cost . . . of *providing*" the UNE to new entrants. This language supports the use of a forward-looking methodology by directing the inquiry to the costs resulting from a new entrant's use of the UNE today, and not what the UNE cost to the ILEC when originally purchased. Any rational firm, including an ILEC, would replace these elements with the most efficient available technologies. *See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 311-12 (1923) (Brandeis, J., concurring) (the proper inquiry "would be, not what it would cost to reproduce the identical property, but what it would cost to establish a plant which could render the service, or in other words, at what cost could an equally efficient substitute be then produced"); *see also Mobil Oil Exploration & Producing Southeast, Inc. v. United Distrib. Cos.*, 498 U.S. 211, 219 (1991). TELRIC properly sets prices based on the "replacement costs" that firms would currently incur to provide the same UNE functions. This approach properly compensates ILECs for the fair value of the assets they use in "providing" UNEs to new entrants, consistent with the language of Section 252(d)(1).[8]

FCC, 28 F.3d 201, 204 (D.C. Cir. 1994). Indeed, for more than half a century, the statutory mandate that rates be "just and reasonable" has been understood as granting an agency discretion to choose between a forward-looking and a historical-cost approach. *Hope Natural Gas Co.*, 320 U.S. at 602; *see* Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* § 3.4 (3d ed. 1994) (agency setting "just and reasonable" rates has discretion in selecting rate methodology to comport with statutory policy decisions).

[8] The ILECs make a weak attempt to distinguish the term "cost" from the term "value." They argue that by compensating ILECs for the replacement cost that would be paid on the open market for the functions of the network element, TELRIC improperly measures "value" not "cost." This purported distinction is overstated. The terms "cost" and "value" are widely recognized as being synonymous. *Webster's New World Thesaurus* 156, 804 (new rev. ed. 1985). The ILECs also ignore the remainder of the statutory language, which requires examination of the "cost . . . of providing" the UNE. This language supports a methodology that looks to the current value of the assets used to provide the UNE functions, for the reasons shown.

Section 252(d)(1) also expressly requires that UNE rates be established "*without reference* to a rate-of-return or other rate-based proceeding . . . ." JA 23 (emphasis added). Historical costs are invariably determined in a rate-of-return proceeding. *See Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1258-59 (D.C. Cir. 1993) ("*Illinois Bell II*"). This statutory language further suggests that Congress did not intend for, let alone mandate that, historical costs be included in UNE prices.

The ILECs also overstate the telecommunications industry's past usage of the term "cost" as requiring a historical cost methodology. Pet'r Br. at 19. Forward-looking cost methodologies have been part of this country's regulatory tradition for over fifty years, and there was a time when this Court believed that the Constitution *mandated* such an approach. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) ("*Duquesne*"). Several states were also implementing forward-looking methodologies to encourage local telephone competition before the Act. JA 334-336, 381 (¶¶ 631, 681). In all events, the FCC was under no obligation to use a particular cost methodology from the *pre*-Act era to implement the pricing provisions of Section 252(d)(1). The Act creates a new regime that fundamentally shifts the provision of local telecommunications services away from the past monopoly environment to a new competitive environment. Congress mandated that new entrants have access to UNEs to compete in the local telecommunications market. The Act did not require the FCC to apply remnants of the old monopoly system to the pricing methodology that it was

jurisdictionally authorized to implement, and the FCC found no reasonable basis to do so.[9]

Finally, the ILECs argue that Congress "clearly" mandated the use of historical costs because Section 252(d)(1)(B) contains the terms "may include a reasonable profit." The ILECs claim that a "reasonable profit" cannot be realized unless all of an ILEC's historical costs are first recouped. This argument fails for several reasons.

Use of "[t]he word 'may' in a statute normally confers a discretionary power, not a mandatory power." *Apex Plumbing Supply, Inc. v. U.S. Supply Co.*, 142 F.3d 188, 192 (4th Cir. 1998) (citation omitted). Congress thus provided the FCC with discretion to incorporate a "reasonable profit" into the pricing methodology, but did not require the agency to do so.

As the Eighth Circuit also noted, "[a] 'profit' can be made whether a historical cost or forward-looking cost methodology is used." *IUB II*, 219 F.3d at 752 (FCC Pet. App. 13a). The FCC addressed this point during the rulemaking, explaining that "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." JA 393 (¶ 700); *see also Burlington N. R.R. v. Surface Transp. Bd.*, 114 F.3d 206, 210, 212-14 (D.C. Cir. 1997) (rates based on forward-looking costs of "hypothetical

[9] The ILECs wrongly suggest that, because the FCC stated in the entirely different context of cable rate regulation that "'[o]riginal cost is the normal, now traditional method used for public utility rate valuation,'" the agency must use a historical cost methodology here. Pet'r Br. at 20 (citation omitted). In implementing the Cable Act, which is governed by a more traditional ratemaking scheme, the FCC was not attempting to choose the measure of cost best suited to opening a market to competition. The FCC is fully authorized to choose a regulatory tool best suited to one context and a different regulatory tool best suited to a different situation.

'stand-alone railroad'" provide "a competitive return on all investments the railroad actually made at their current value"). Thus, an ILEC can "obtain a 'reasonable profit' without recovering all of its embedded costs." *Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc.*, No. A 97-CA-132 SS, 1998 WL 657717, at *11 (W.D. Tex. Aug. 31, 1998) ("*SWBT*"); *see also GTE S., Inc. v. Morrison*, 6 F. Supp. 2d 517, 529 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999) ("*GTE South*").

Lastly, in a competitive environment, market forces drive rates to forward-looking costs. JA 379-380 (¶ 679). Profits in excess of forward-looking costs are not "normal." Edwin Mansfield, *Microeconomics* 252-53 (6th ed. 1988); *SWBT*, 1998 WL 657717, at *10; *see* JA 393-395 (¶ 700). By arguing that forward-looking costs do not provide them with a "reasonable profit," the ILECs essentially argue that they are entitled to more profit than is available in either a competitive or a regulated market. While the ILECs may prefer such a windfall, the Act does not *allow*, much less require, it. The FCC was not authorized to include anything more than a "normal" profit in its forward-looking cost methodology. Had the FCC granted ILECs a "supra-normal" profit, as they apparently urge, the agency would have violated the Act's mandate that rates be "reasonable." JA 393-394 (¶ 700 & n.1707).

B. Other Provisions Of The Act Do Not Compel The Use Of Historical Costs For UNE Pricing.

1. The Act Expresses No Preference For Historical Cost Models And There Is No Reason To Infer One.

Congress required the FCC to "complete all actions necessary to establish regulations to implement" the Act within six months. JA 14. From this "congressional desire for swift action," and Section 252(d)(1)'s proscription against

the use of "rate-of-return or other ratemaking proceeding[s]," the ILECs attempt to infer that Congress intended for the term "cost" to mean "already established and readily available" historical costs. Pet'r Br. at 22. This argument rests on the false premise that forward-looking cost models are "novel, complex, and difficult-to-administer," while historical cost models are easy to use and ready off-the-shelf. *Id.*

Modern economic modeling has made forward-looking cost methodologies, in the words of the FCC, both "practical and implementable." JA 381 (¶ 681); *see also American Public Gas Ass'n v. Federal Power Comm'n*, 567 F.2d 1016, 1036-37 (D.C. Cir. 1977) (forward-looking cost methodologies have been routinely used by regulatory agencies to establish rates). Numerous courts and agencies have specifically endorsed forward-looking cost methodologies where the regulatory goal is "to encourage competition." *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 411-12 & nn.12-13 (5th Cir. 1999), *cert. granted sub nom. GTE Serv. Corp. v. FCC*, 530 U.S. 1213, *cert. dismissed*, 121 S. Ct. 423 (2000) ("*GTE*"). Most experts within and outside the government also agree that a historical cost approach is no less difficult or complex to administer than a forward-looking model. JA 333-334, 340-342 (¶¶ 630, 635).

The notion that the FCC was incapable of evaluating anything but a historical cost methodology during the six-month rulemaking period established by the Act is far-fetched and readily disproved by the administrative record. The FCC evaluated several approaches—including historical and forward-looking cost methodologies—in promulgating implementing regulations for Section 252(d)(1). The *Local Competition Order* contained over 100 paragraphs addressing pricing methodologies and was issued within the six-month

statutory timeframe. JA 325-423 (¶¶ 618-740).[10] Moreover, the Act contemplated that these new rules, once issued, would be applied by the state commissions to establish actual UNE rates in individual arbitrations over at least another nine-month period. JA 21-22.

The ILECs' argument also wrongly presumes that state commissions would be incapable of applying anything other than historical cost models in setting UNE rates. This claim similarly is disproved by the record. State commissions have not found TELRIC "novel, complex, and difficult-to-administer." Pet'r Br. at 22. In the five years since the Act's passage, state commissions throughout the country have established UNE rates using TELRIC. *See, e.g., GTE South*, 6 F. Supp. 2d at 526-30; *SWBT*, 1998 WL 657717, at *16 (upholding Texas PUC's use of TELRIC and finding TELRIC "compelled" by the Act). Indeed, many state commissions independently decided to use TELRIC during the period when the FCC's pricing rules were invalidated by the Eighth Circuit on jurisdictional grounds.

Lastly, there is no reason to believe that a historical cost methodology would be easier to apply or would result in more accurate rates than other cost models, as the ILECs wrongly suggest. In 1990, the FCC moved away from traditional cost of service regulation based on historical costs and adopted a "new system" of price cap regulation. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990). Historical costs, therefore, were not "readily available" to the agency and would have had to be

---

[10] The ILECs contend that due process requires "notice and a right to be heard" when a change in rate methodology affects a firm's recovery. Pet'r Br. at 22 n.13, 47. The ILECs received notice of and participated in the proceedings before the FCC, thereby satisfying any purported "due process" concerns. JA 328 (¶ 622) (describing Notice of Proposed Rulemaking requesting comments on the type of pricing methodology for network elements), JA 359-361 (¶ 655) (describing ILECs' argument for the use of historical costs).

developed essentially from scratch. The historical costs carried on an ILEC's books are not generally allocated to particular categories of network elements. The relevant inputs to historical cost models, therefore, cannot be calculated by simply adding up a series of historical cost figures. The need for economic modeling to determine and verify particular network element prices still exists with the use of historical costs. *GTE South*, 6 F. Supp. 2d at 527 (upholding Virginia commission's refusal to adopt GTE's historical cost model which was labeled a "black box" because its operation and assumptions could not be tested or effectively challenged by others). For these reasons, there is no basis to presume that use of historical costs would be any less difficult or complex to administer than a forward-looking cost model. *See National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993) ("rate of return regulation is costly to administer, as it requires the agency endlessly to calculate and allocate the firm's costs") ("*National Rural Telecom*"). To the contrary, the complexity and unwieldiness of rate-of-return proceedings has led many agencies to abandon historical cost pricing. Regulators have increasingly found forward-looking cost methodologies to be more reliable and practical than historical cost models. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 9.2 (1st ed. 1992) ("In practice, rate of return regulation usually culminates in poor regulation of cost, with prices allowed to float upward."), *id.* § 9.8 ("We now know that by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction.").

2. The Act's Resale Pricing Provision Does Not Implicitly Endorse Historical Or Forward-Looking Cost Models.

The ILECs also wrongly contend that the Act's resale pricing provision, 47 U.S.C. § 252(d)(3), demonstrates a

congressional intent to use historical costs to price network elements. Pet'r Br. at 22-23. Section 252(d)(3) requires ILECs to provide their retail services to new entrants at wholesale discounts for resale. The resale price is based on the ILEC's retail tariffs, regardless of how those retail tariffs are set in a particular state. In those states that establish retail tariffs based on forward-looking cost models, the wholesale discount price would reflect that cost methodology. JA 438-439 (¶ 915). Conversely, in those states that use historic cost methodologies, the wholesale discount price would reflect those models. *Id.* Section 252(d)(3) is thus agnostic as to the cost methodology used by a particular state. Neither Congress nor the FCC expressed any preference for setting wholesale rates based on historical costs.[11]

C. The FCC's Choice Of A Forward-Looking Cost Methodology Was Not Arbitrary Or Capricious And Is Entitled To Deference.

The Eighth Circuit correctly held that the FCC's use of a forward-looking cost methodology was reasonable and well-explained. *IUB II*, 219 F.3d at 752 (FCC Pet. App. 12a). The ILECs dispute the FCC's choice, arguing that: (1) historical costs would be a better measure than forward-looking costs; (2) forward-looking costs methodologies are "unmanageable"; and (3) the FCC failed adequately to explain its reasons for "abandoning" historic costs. Pet'r Br. at 44-49. These challenges, at bottom, relate to the wisdom of the FCC's policy decision that a forward-looking cost methodology would better serve Congress' goal of rapid competition than a historical cost model. Under *Chevron*, that policy decision was for the FCC to make. 467 U.S. at 865 ("When a challenge to an agency construction of a statutory provision,

[11] The ILECs' reference to the Act's resale pricing standards is ironic, since they argue elsewhere that their retail rates are often established at prices "substantially *below* cost." *See* Pet'r Br. at 4 (emphasis added).

fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.").

1. Historical Costs Are Antithetical To The Act's Objectives.

The FCC did not exclude historical cost models on a whim. The agency carefully considered the issue and concluded that pricing UNEs based on the historical or "embedded" costs carried on an ILEC's accounting books would be *antithetical* to the pro-competitive goals of the Act. The FCC recognized that these historical costs could be higher or lower than the costs derived from a forward-looking cost model. JA 398-399 (¶ 705). Even so, the FCC reasoned that the use of historical costs in determining the rates paid by new entrants would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry contemplated by the . . . Act." JA 399 (¶ 705). Allowing ILECs to price UNEs based on historical costs would force new entrants to price their retail services based on those costs. Because ILECs control the only facilities currently available to provide widescale local service, they could then undercut the prices of any potential competitors. JA 441-442 (¶ 1065). An incumbent could "set its own rates based on the present value of providing the service"—that is, by writing off obsolete investments just as a competitive firm would—while forcing competitors to "pass along to [their] customers the inflated, monopoly-era historical costs [the ILEC] seeks to charge new entrants." *SWBT*, 1998 WL 657717, at *13. Forward-looking pricing for network elements, by contrast, places everyone "on a level playing field." *Id.*; *see also Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 18-19 (1st Cir. 1990) (Breyer, J.). As the FCC explained, "[t]he substantial weight of economic commentary in the record suggests that an 'embedded cost'-based pricing methodology would be

pro-competitor—in this case the incumbent LEC—rather than pro-competition." JA 398 (¶ 705). The FCC thus concluded that historical cost pricing would frustrate the Act's objectives. JA 398-399 (¶ 705).

The FCC also built sufficient flexibility into TELRIC to ensure that state commissions account for the effects of competition on ILECs. State commissions must consider these effects in setting the depreciation rates and cost of capital. JA 395-396 (¶ 702). The FCC found that:

> the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate.

JA 395 (¶ 702). "States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted." JA 396 (¶ 702). Thus, contrary to the ILECs' claims, TELRIC allows state commissions to account for the effects of competition on investment incentives.

2. TELRIC Is Not "Unmanageable."

The ILECs' characterization of TELRIC as "unmanageable" is factually incorrect, Pet'r Br. at 45, for the reasons previously shown. The FCC made a reasoned determination that TELRIC would be "implementable" based on the proven experience of various state commissions. JA 334-336, 381 (¶¶ 631, 681). The practical experience of these state commissions was especially informative because, as the FCC recognized, state commissions would be the ones establishing UNE rates based on the FCC's methodology. JA 381 (¶ 681). Virtually every state commission has applied TELRIC in *post*-Act arbitrations, confirming the soundness of the FCC's

determination that TELRIC would be manageable to implement. Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.4.4.2 (2d ed. 1999).[12]

3. The FCC Did Not "Abandon" Historical Cost Models.

In a final attempt to portray the FCC's rulemaking as "arbitrary and capricious," the ILECs claim that the FCC failed adequately to explain its "decision to abandon historical costs in favor of TELRIC." Pet'r Br. at 46 This claim rests on a false premise. Prior to the Act, ILECs had no obligation to lease UNEs to competitors and the FCC was never called on to establish a cost methodology for UNE access. TELRIC is not an abrupt change from past practices. It is part of the FCC's implementation of an entirely *new* regime. Far from abandoning a settled methodology, the FCC was charged with promulgating a new one that provided just and reasonable compensation while promoting Congress' goal of rapid competition. The FCC fully explained its reasons for selecting a forward-looking cost methodology and

[12] The ILECs utterly ignore the fact that TELRIC has been successfully implemented by the states and argue instead that TELRIC is an "unmanageable project" based on the FCC's experience in the universal service proceeding. Pet'r Br. at 45; *see also id.* at 12-13. That is not a valid comparison. The states' actual experience with TELRIC is the most relevant inquiry. The FCC's universal proceedings are vastly more complicated than a state commission arbitration to determine UNE prices for an individual ILEC. Congress created a wholesale change in the way universal service would be advanced nationally in the *post*-Act environment. JA 29-48. To implement these requirements, the FCC has conducted a complex, ongoing nationwide proceeding, which involves all state commissions, virtually all local and long distance carriers and other interested parties, and requires the FCC to work with and receive recommendations from a joint federal-state board. *Id.*; *see also* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 2.5 (2d ed. 1999) ("Perhaps the most daunting task assigned to the [FCC] by the 1996 Act was a thorough review and restructuring of the existing federal universal-service guarantees.").

for rejecting the use of historical costs. JA 325-423 (¶¶ 618-740). It was within the FCC's authority to make these determinations and its selection of TELRIC was not arbitrary or capricious.

II. THE FCC's SELECTION OF THE TELRIC METHODOLOGY DOES NOT VIOLATE THE TAKINGS CLAUSE.

The FCC's decision to exclude historical costs in the UNE rates that ILECs may charge new entrants does not violate the Takings Clause. Pet'r Br. at 24-26. The ILECs construct three arguments in an attempt to implicate constitutional takings principles. They first claim that the FCC's implementation of TELRIC was an "opportunistic switch" from a prior, well-settled historical cost methodology that provided for recovery of past prudent investment. *Id.* at 26-31. They next attack the TELRIC methodology itself, which they contend will force them to lease UNEs to new entrants at "a loss." *Id.* at 31-42. Finally, they argue that this Court must adopt a narrow construction of Section 252(d)(1)—which, in their view, would require the incorporation of historical costs—in order to avoid "serious constitutional questions" raised by TELRIC. *Id.* at 42-44. None of these claims has merit.

A. TELRIC Does Not Represent A Constitutionally Suspect Shift In Methodologies.

The ILECs wrongly argue that, in adopting TELRIC, the FCC "abandoned the longstanding regime under which incumbents were given the opportunity to recover their actual investment and moved to an extreme version of replacement costs." *Id.* at 26. "This fundamental shift," the ILECs contend, "necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime." *Id.*

The ILECs' attempt to cast TELRIC as a "fundamental switch" in cost methodologies is overstated. The Act does not purport to impose any cost methodology on the states in setting retail rates for an ILEC's traditional local services. Any purported "expectations" the ILECs may have based on the particular methodologies employed by the states for these services—whether they be based on historical or forward-looking costs—are unaffected by the Act. The Act's pricing standards instead apply to an entirely new regime that is designed to open local markets to rapid competition. ILECs had no prior obligation to provide UNEs to new entrants and there was no established methodology for pricing these elements. The TELRIC methodology was chosen by the FCC to implement the Act's pro-competitive requirements. The FCC was not bound by any particular methodology used to set rates in the *pre*-Act monopoly environment in determining how UNEs should be priced in the new competitive environment. Nor did the ILECs have any vested right to expect that they would be shielded from a methodology based on forward-looking rather than historical costs. As this Court explained decades ago:

> [w]hether competition between utilities shall be prohibited, regulated or forbidden is a matter of state policy. That policy is subject to alteration at the will of the legislature. The declaration of a specific policy creates no vested right to its maintenance in utilities then engaged in the business or thereafter embarking in it.

Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118, 141 (1939) ("*Tennessee Electric*").

The ILECs also wrongly attempt to use *Duquesne* as authority for the proposition that, whenever a regulatory agency adopts a new rate methodology, it must guarantee that the carriers recover "all their previous prudent investment and an appropriate rate of return under the old methodology." Pet'r Br. at 27. Thus, once regulators base rates on historical costs, the ILECs contend, it creates a promise that must be

honored under the Constitution. Any change in future rates must provide for recovery of those costs, regardless of the present value of the underlying network assets. *Id.*

Duquesne expressly refutes the ILECs' proposition that recovery of historical costs is constitutionally required. The Takings Clause prevents rates that are "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired." *Duquesne*, 488 U.S. at 307; *see also Market St. Ry. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 567 (1945) (the Takings Clause prevents only "governmental destruction of *existing economic values*" and does not require compensation based on "the present reproduction value of something no one would presently want to reproduce" or the "historical valuation of a property") (emphasis added) ("*Market Street Railway*"). Indeed, prior to *Duquesne*, "it was thought that the Constitution *required*" compensation based on "present value." *Duquesne*, 488 U.S. at 308 (emphasis added). In *Duquesne*, this Court explained that the Constitution does not mandate a single theory of valuation, stating, in pertinent part, that:

> [C]ircumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the [regulators] free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

Id. at 316; *see also Hope Natural Gas*, 320 U.S. at 602 (The Takings Clause does not confine regulators "to the use of any single formula or combination of formulae in determining rates."). Under *Duquesne*, therefore, the FCC had broad authority to establish a cost methodology for UNE rates that, in the agency's expert view, "best meets" the objectives of the new Act, regardless of the cost methodologies used by the agency or the states in the *pre*-Act regime.

Even assuming, for argument's sake, that TELRIC represented a "shift" in methodologies, it would not raise a serious constitutional question. As shown, TELRIC provides just compensation to the ILECs by permitting full recovery of the current fair value of the UNEs. The Takings Clause requires no greater compensation, *see United States v. Miller*, 317 U.S. 369, 374 (1943), and the ILECs have no right to expect more. The ILECs acknowledge that the measure for evaluating an alleged property deprivation is the reasonable, investment-backed expectations of the property owner. Pet'r Br. at 29. This Court has repeatedly held that reasonable investors cannot expect an existing ratemaking scheme to be permanent or claim entitlement to particular regulatory treatment. *E.g.*, *Tennessee Electric*, 306 U.S. at 141; *see also American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 397, 416 (1967). *Cf. New York Cent. R.R. v. White*, 243 U.S. 188, 198 (1917) ("No person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit."). It is thus constitutionally permissible for a regulatory agency to establish new rates based on a changed methodology that excludes historical costs prudently invested. In *Duquesne*, for example, this Court upheld rates that reflected the "current market value" of the utility's investments, even though this approach denied recovery of tens of millions of dollars of prudently incurred historical expenditures. 488 U.S. at 312-14. Similarly, in *Hope Natural Gas*, the Court affirmed the adoption of a new approach for calculating the rate base, even though the resulting rates "might produce only a meager return" on the prior rate base. 320 U.S. at 605. In *Market Street Railway*, the regulatory commission based rates on the present value of a company's assets ($7.95 million), even though the "book value" of the property exceeded $41 million and its "historical reproduction costs" exceeded $25 million. 324 U.S. at 564-68. The Court held that the regulated entity was not constitutionally entitled to compensation based on

"the historical valuation of a property whose . . . current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made." *Id.* at 567; *see also In re Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968) (Courts will not "set aside [a rate order] merely because the [regulatory agency] has on an earlier occasion reached another result.") ("*In re Permian Basin*"). These authorities make clear that the ILECs and their investors had no reasonable basis to "count on" a historical cost methodology "as a necessary component for supplying a constitutional return under the old regime." Pet'r Br. at 30.

Duquesne also establishes that changes in regulatory treatment implicate the Takings Clause only under narrow circumstances; *viz.*, when the state "arbitrarily switch[es] back and forth between methodologies in a way which require[s] investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." 488 U.S. at 315. The FCC adopted TELRIC to implement the Act's new UNE access requirements. The agency has not arbitrarily switched "back and forth" between cost methodologies and nothing in the record remotely resembles such opportunistic rate manipulation. Moreover, as shown, the FCC had moved away from traditional cost of service regulation based on historical costs in favor of price cap regulation several years before the Act's passage. *Policy and Rules Concerning Rates for Dominant Carriers*, 5 F.C.C.R. 6786 (1990). Price cap regulation establishes rates by considering, among other things, "expected savings from innovation and other economies" that are necessarily "forward-looking." *National Rural Telecom*, 988 F.2d at 178. It is indeed ironic for the ILECs to claim that the FCC's so-called "switch" to TELRIC has a constitutional dimension here, given that they did not challenge the constitutionality of the FCC's "switch" from

traditional cost of service regulation to price cap regulation over a decade ago.

In addition to the legal flaws in the ILECs' analysis, their claim that the purported "switch" to TELRIC "wipe[s] out a significant portion of the recovery on past investments" lacks any credible factual basis. The ILECs assert that they have invested $342 billion in their networks over time, based on newly introduced data that they provided to the FCC in a separate, unrelated context. Pet'r Br. at 10-11. Apart from the questionable relevance of these data, they show that approximately $176 billion of that original investment has been *depreciated* on the ILECs' books—a point conveniently missing from the ILECs' analysis. *1999 Statistics of Communications Common Carriers*, table 2.9, at 51 (rel. Aug. 11, 2000). Even under a historical cost methodology, the ILECs' original investment is worth only $166 billion today based on their own data. *Cf. Illinois Bell II*, 988 F.2d at 1258-59 & n.5 ("Since depreciation is an operating cost, investors recover such amounts dollar for dollar.") (citing Breyer & Stewart, *Administrative Law and Regulatory Policy* 237 n.59 (2d ed. 1985)). In comparison, the ILECs contend that TELRIC values those same assets at $180 billion. Pet'r Br. at 10-11. The ILECs' argument that TELRIC "under-values" their networks and "strands" historical costs in a "harshly retroactive" way is thus wholly unsupported.

Although there is no evidence in the record regarding the extent of UNE leasing by new entrants, it is beyond dispute that ILECs continue to control more than 92% of the local markets. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 1 (May 2001). The ILECs, therefore, continue to recover the vast majority of their "historical" network costs through the retail rates established by the state commissions in traditional intrastate rate-of-return proceedings. It seems likely that most, if not all, of an ILEC's undepreciated historical costs existing in 1996 will have been recovered through its retail

rates long before any meaningful UNE-based competition takes hold.

B. The ILECs' Theoretical Attacks On TELRIC Are Barred By The Well-Settled "Total Effect" Test For Regulatory Takings.

This Court has held that "[i]t is not theory but the impact of the rate order which counts." *Hope Natural Gas*, 320 U.S. at 602. Accordingly, the Court has rejected theoretical challenges to rate methodologies and examined instead the "total effect" of actual rates for takings purposes. *Id.* An uncompensated taking results only if *application* of the ratemaking methodology produces overall rates so low as to "jeopardize the [regulated entity's] financial integrity . . . either by leaving [it with] insufficient operating capital or by impeding [its] ability to raise future capital." *Duquesne*, 488 U.S. at 312. This "total effect" test is necessary to ensure that regulators have sufficient methodological leeway to resolve the complicated economic judgments and difficult policy issues involved in setting rates. *Id.* at 314.

The ILECs make no credible attempt to satisfy the "total effect" test in challenging TELRIC. Rather, they contend that the FCC "misapplied" the test "by looking to revenues earned from *all* of an incumbent's operations" in order to "cure" the "below-cost" UNE rates resulting from TELRIC. Pet'r Br. at 32 (emphasis in original). Relying on *Brooks-Scanlon Co. v. Railroad Commission of Louisiana*, 251 U.S. 396, 399 (1920) ("*Brooks-Scanlon*"), the ILECs argue that the FCC may not set "below-cost" rates in one line of business and offset any such deficiency from revenues in a different, unregulated line of business. Pet'r Br. at 33-34.

These arguments mischaracterize the record. TELRIC does not result in "below-cost" rates. As previously shown, TELRIC allows for full recovery of an ILEC's costs plus a reasonable profit, based on a forward-looking methodology.

Nor did the FCC "'distort[]' the *Duquesne* 'total effect' test by claiming that it could look to *all* of an incumbent's overall revenues to make up for any deficiency in TELRIC rates," as the ILECs wrongly suggest. *Id.* at 32 (citing JA 421-422 (¶ 738)) (emphasis in original). The agency explained its analysis as follows:

> In adopting the rules that govern [UNE] rates, under *Hope Natural Gas* we must consider whether the end result of incumbent LEC rates is just and reasonable. Incumbent LECs argue that establishing a rate structure that does not permit recovery of historical or embedded costs is confiscatory. We disagree. As stated above, the Court has consistently held since *Hope Natural Gas* that it is the end result, not the method used to achieve that result, that is the issue to be addressed. . . . Moreover, the Court has upheld as reasonable changes in ratemaking methodology when the change resulted in the exclusion of historical costs prudently incurred. Thus, the mere fact that an incumbent LEC may not be able to set rates that will allow it to recover a particular cost incurred in establishing its regulated network does not, in and of itself, result in confiscation.
>
> Moreover, *Hope Natural Gas* requires only that the end result of our overall regulatory framework provides LECs a reasonable opportunity to recover a return on their investment. In other words, incumbent LECs' overall rates must be considered, *including the revenues for other services under our jurisdiction.*

JA 420-421 (¶¶ 736-737 & n.1756) (emphasis added). The record thus shows that the FCC properly analyzed the ILECs' theoretical "taking" claims to TELRIC under this Court's precedents. The FCC did not look to revenues from unregulated segments of the ILECs' businesses, as the ILECs claim, but rather expressly confined its analysis to whether the "end result of [the agency's] overall regulatory framework" provided for just compensation, including the ILECs'

revenues from other services expressly under the FCC's jurisdiction.[13]

Based on the evidence before it, the FCC concluded that TELRIC "should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings. We believe that a forward-looking economic cost methodology enables incumbent LECs to recover a fair return on their investment, *i.e.*, just and reasonable rates." JA 421-422 (¶ 738). Even so, the FCC ordered that ILECs "may seek relief from the Commission's pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." JA 422 (¶ 739).

The ILECs' reliance on *Brooks-Scanlon* is thus misplaced. In *Brooks-Scanlon*, this Court held that the regulatory agency could not look to the profits earned by a railway company in a separate, unregulated lumber business to subsidize losses being incurred by the company in a regulated, unprofitable rail line. 251 U.S. at 399. As shown, the FCC based its analysis on the markets it regulates, not on any unregulated businesses of the ILECs. *Brooks-Scanlon* was also decided before this Court adopted the "total effect" test. Subsequent decisions have held that *Brooks-Scanlon* in no way precludes an agency from considering revenues from all parts of an entity's regulated business when applying the test. *See, e.g.*, *Baltimore & Ohio R.R. v. United States*, 345 U.S. 146, 150 (1953); *In re Valuation Proceedings Under §§ 303(c) & 306*

---

[13] The above-cited record also shows that the FCC properly looked to this Court's precedents on just compensation, and did not attempt to interpret on its own "what costs the Constitution requires" to be recovered—as the ILECs wrongly suggest. Pet'r Br. at 25-26. The Court should reject the ILECs' attempt to parlay this fictitious argument into another ground for negating *Chevron* deference to the FCC's interpretation of "cost" in Section 252(d)(1).

of the Reg'l Rail Reorg. Act, 439 F. Supp. 1351, 1357 n.12 (Regional Rail Reorg. Ct. 1977).

Rather than coming forward with any specific information to prove a confiscatory rate, the ILECs have attempted instead to rewrite this Court's regulatory takings jurisprudence. In so doing, the ILECs have turned *Duquesne* on its head. As shown, *Duquesne* holds that there is no single rate methodology mandated by the Constitution and that it is constitutionally permissible for a ratemaker to change methodologies, even where doing so excludes historical costs prudently invested. The ILECs argue just the opposite here, stating that:

> [t]he FCC thus failed to conduct the inquiry *demanded* by *Duquesne*—whether TELRIC rates for UNEs will preserve incumbents' opportunity to recover their past prudent investment.

Pet'r Br. at 37 (emphasis added). This assertion demonstrates that it is the ILECs—not the FCC—that have misapplied *Duquesne*.

The ILECs' attempt to avoid the "total effect" test is not surprising, since "[o]nly the most egregiously confiscatory rate structure would have difficulty meeting" the "total effect" test reaffirmed there. Laurence H. Tribe, *American Constitutional Law* § 9-3 n.3 (2d ed. 1988). A utility thus bears a heavy burden in proving that rates are confiscatory under this standard. *In re Permian Basin*, 390 U.S. at 767. The ILECs failed to meet that burden before the FCC, JA 421-422 (¶ 738), and they have failed to meet it here. Although they broadly assert in their merits brief that state commissions "applying TELRIC ... typically produced discounts of 50% below historical cost," this "evidence" is based on the self-serving testimony of a single witness in an arbitration. The ILECs' claim that TELRIC leaves billions in network costs "stranded" is also belied by their own data, as shown *supra* pp. 33-34. These claims fail to demonstrate that

the "total effect" of the FCC's pricing rules is so unjust as to be confiscatory. The ILECs have not shown that they are unable to maintain their financial integrity or to attract necessary capital as a result of TELRIC or the Act's overall pricing scheme. *See Duquesne*, 488 U.S. at 312; *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc).[14] Nor have they attempted to account for the substantial new sources of revenue that the Act now makes available to them by, among other things, allowing them access to the various long distance and other markets foreclosed by the AT&T consent decree. The ILECs' failure to come forward with any such evidence, five years after the Act was adopted, leaves no doubt that their "constitutional" challenge to TELRIC is not really based on takings principles, but rather on the policy choices properly made by the FCC.[15]

Finally, rejection of the ILECs' theoretical challenges to the TELRIC methodology will not foreclose judicial review of whether TELRIC-derived rates are themselves "confiscatory." Pet'r Br. at 40. *Duquesne* explicitly holds that a takings challenge must be based on the effect of a rate, not the methodology employed. The Act authorizes state commissions to conduct arbitrations to establish UNE rates and provides an avenue for judicial review of those

---

[14] To the contrary, the ILECs' stock values have appreciated substantially since August 8, 1996, the date the FCC released its *Local Competition Order*. *See* Yahoo Finance Historical Quotes, *available at* http://chart.yahoo.com/d (providing split-adjusted historical stock data showing that from August 8, 1996 to June 1, 2001 stock prices for (i) BellSouth rose from $19.11 per share to $40.56 per share; (ii) SBC rose from $22.12 per share to $42.05 per share; and (iii) GTE/Verizon rose from $25.82 per share to $54.74 per share).

[15] The fact that the FCC has not concluded its Universal Service Order ("USO") proceedings does not save the ILECs' "takings" claim. The ILECs receive explicit universal service support, as well as compensation from the Act's other pricing provisions. JA 29-48.

determinations. JA 25-26. As much as the ILECs may prefer to challenge the constitutionality of the FCC's methodology in this proceeding, such a challenge can only proceed after the UNE rates that are a product of that methodology have been set and the effect of those rates can be tested.

C. The Doctrine Of Constitutional Avoidance Does Not Require The Inclusion Of Historical Costs In UNE Prices.

Having constructed their theoretical "takings" challenge to TELRIC, the ILECs next argue that the doctrine of "constitutional avoidance" negates *Chevron* deference and requires this Court to interpret Section 252(d)(1) in a way that avoids raising "serious constitutional questions." Pet'r Br. at 42. These questions can only be avoided, the ILECs contend, by interpreting the statute their way; *viz.*, to include historical costs. The Eighth Circuit correctly rejected this argument. *IUB II*, 219 F.3d at 754 (FCC Pet. App. 16a-18a). This Court should do the same.

The doctrine of constitutional avoidance is inapplicable in these circumstances because the Act provides a mechanism for the ILECs to receive compensation through state-arbitrated UNE rates. The Fifth Amendment does not proscribe the taking of property. "[I]t proscribes the taking of property without just compensation." *Williamson County Reg'l Planning Comm'n v. Hamilton Bank*, 473 U.S. 172, 194 (1985) ("*Williamson County*"). The Fifth Amendment requires only that an adequate mechanism for compensation exist. *Id.*

A narrowing construction of a statute to avoid a constitutional problem need only be invoked in those cases in which the application of a statute will necessarily constitute a taking and no means of compensation exists. Thus, in *Riverside Bayview Homes*, this Court did not invoke the doctrine of constitutional avoidance because (1) the regulation did not necessarily constitute a taking, and (2) even

if it did, a mechanism for compensation existed via the Tucker Act. The Court explained that, as long as compensation is available for those whose property is in fact taken, the government action is not unconstitutional. Because the availability of compensation negates any constitutional concerns, "adoption of a narrowing construction does not constitute an avoidance of a constitutional difficulty, it merely frustrates permissible applications of a statute or regulation." *Riverside Bayview Homes*, 474 U.S. at 128. As this Court explained,

> the possibility that the application of a regulatory program may in some instances result in the taking of individual pieces of property is no justification for the use of narrowing constructions to curtail the program if compensation will in any event be available in those cases where a taking has occurred.

Id.[16] *See also Railway Labor Executives' Ass'n v. United States*, 987 F.2d 806, 816 (D.C. Cir. 1993) ("Because just compensation is presumptively available under the Tucker

---

[16] Contrary to the ILECs' assertion, it was appropriate for both the FCC and the Eighth Circuit to rely on *Riverside Bayview Homes* as support for the argument that a limiting construction of the Act is not warranted. The ILECs criticize the FCC and the Eighth Circuit for supposedly reading *Riverside Bayview Homes* to establish a general exemption from the principle of constitutional avoidance when the issue involves the Takings Clause. Pet'r Br. at 43-44. Neither the FCC nor the Eighth Circuit even suggested that *Riverside Bayview Homes* stands for that proposition. Rather, the case stands for the principle that the doctrine of constitutional avoidance should only be invoked when a taking necessarily occurs and there is no means available for compensation. When that principle is applied in this case, it is clear that a narrowing interpretation is not warranted. By contrast, in *Bell Atlantic Telephone Cos. v. FCC*, 24 F.3d 1441 (D.C. Cir. 1994), a *pre*-Act case that, like *Riverside Bayview Homes*, involved the doctrine of constitutional avoidance, the D.C. Circuit applied a limiting construction to the Communications Act and vacated FCC regulations that required local exchange carriers to provide physical collocation because the Communications Act did not expressly authorize such a taking or provide a compensation mechanism for it. *Id.* at 1445.

Act, there is neither an unconstitutional result nor a constitutional doubt to be averted by interpretation.").

Just as the Tucker Act provided a means for compensation in the *Riverside Bayview Homes* and *Railway Labor* cases, and thereby removed the need for a limiting construction of the statutes at issue, the UNE compensation provisions of Section 252(d)(1) remove the need for any limiting construction of the statute to "avoid" a constitutional problem here. As the ILECs concede, the Act embodies the constitutional standard for just compensation. Their real argument is with the FCC's choice of TELRIC to provide it. The FCC was authorized to adopt a forward-looking cost model. That choice—even if deemed a "switch" in methodologies, as the ILECs contend—allows for adequate recovery by ILECs of their costs of providing UNEs to new entrants. TELRIC is thus consistent with the requirements of Section 252(d)(1) and the Takings Clause.

Moreover, as shown, an agency's choice between prudent-investment, historical cost, forward-looking cost, and replacement cost methodologies does not raise constitutional questions *per se*. Each method may provide just compensation when reasonably applied. Conversely, each method could result in unjust rates if misapplied. For these reasons, courts require financial data showing the actual effect of rates —not abstract methodological challenges—when evaluating a takings claim. The ILECs' takings claim is based solely on the choice of methodology made by the FCC and not on any credible evidence that TELRIC-derived rates are confiscatory.

The FCC has also ordered the ILECs to seek relief from the agency should they have credible evidence that TELRIC, "as applied to them, will result in confiscatory rates." JA 422 (¶ 739). The ILECs have yet to avail themselves of that remedy, which itself forecloses a takings challenge at this time. *See Williamson County*, 473 U.S. at 194-96.

Finally, TELRIC is not a "novel" methodology that tests "the outer limits of Congress' power," as the ILECs attempt to suggest. Pet'r Br. at 43. Forward-looking cost methodologies like TELRIC have been widely accepted in the professional literature, were implemented by several state utility commissions prior to passage of the Act, *see* JA 334-336 (¶ 631 & nn.1508-14), and have already passed constitutional muster, *see GTE*, 183 F.3d at 411-13 & nn.12-13.

Under these circumstances, adoption of a narrowing construction of Section 252(d)(1) would not "avoid" any serious constitutional question. It would instead frustrate the FCC's lawful interpretation of the provision to implement the Act's pro-competitive objectives. As the Eighth Circuit correctly found, there is no "need to disregard *Chevron* deference and interpret the statute in accordance with the [ILECs'] views in order to avoid an unconstitutional taking in this instance." *IUB II*, 219 F.3d at 754.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court affirm the FCC's UNE pricing rules in all respects.

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent
Sprint Corporation

No. 00-511

IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR RESPONDENTS WORLDCOM, INC., THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES, AND COMPETITIVE TELECOMMUNICATIONS ASSOCIATION

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.*
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Respondent WorldCom, Inc.

* Counsel of Record

[*Additional Counsel Listed on Inside Cover*]

June 8, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCAL TELECOMMUNICATIONS
SERVICES
888 17th Street, N.W.
Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Respondent the Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE
TELECOMMUNICATIONS
ASSOCIATION
1900 M Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Respondent Competitive Telecommunications Association

QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioners state as follows:

WorldCom, Inc.

WorldCom, Inc., through its wholly-owned subsidiaries, provides local and long-distance telecommunications services domestically and internationally. WorldCom, Inc. is a publicly traded company on the Nasdaq National Market under the symbol "WCOM." No publicly held company owns 10 percent or more of WorldCom, Inc. stock.

The Association for Local Telecommunications Services

The Association for Local Telecommunications Services ("ALTS") is the national trade association representing facilities based providers of competitive local telecommunications services. ALTS has no parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.

Competitive Telecommunications Association

The Competitive Telecommunications Association ("CompTel") is a national industry trade association representing competitive telecommunications carriers and their suppliers. Its over 300 members include large nationwide suppliers as well as scores of smaller regional carriers. CompTel has not issued shares or debt securities to the public. CompTel does not have any parent companies, subsidiaries, or affiliates that have issued shares or debt securities to the public.

TABLE OF CONTENTS

QUESTION PRESENTED i

RULE 29.6 STATEMENT ii

TABLE OF AUTHORITIES v

BRIEF FOR RESPONDENTS 1

COUNTERSTATEMENT 3

A. The Bell System Monopoly and the Onset of Competition. 3

B. The Move Toward Local Competition 5

C. The 1996 Act 6

D. The FCC's Implementation of the 1996 Act 8

E. Judicial Review 10

F. Local Competition Since the 1996 Act 11

SUMMARY OF ARGUMENT 13

ARGUMENT 15

I. THE 1996 ACT DOES NOT MANDATE RATES BASED ON THE INCUMBENTS' HISTORICAL COSTS. 15

II. THE JUST COMPENSATION CLAUSE PROVIDES NO REASON TO INVALIDATE THE FCC'S CHOICE OF TELRIC. 21

A. Incumbents' Constitutional Claim Fails on Its Own Terms. 25

1. *There is no basis in the record for the incumbents' Takings arguments.* 25

TABLE OF CONTENTS - continued

2. *The FCC's supplemental mechanism to consider stranded cost issues eliminates any Takings concerns.* 31

B. The Incumbents Have Not Shown That the Total Effect of TELRIC Will Be Confiscatory. 32

C. There Has Not Been an Unconstitutional "Switch" in Methodologies. 35

1. *Nothing in this Court's jurisprudence precludes or limits a one-time switch in methodologies.* 36

2. *The "shift" in methodologies did not upset reasonable investor expectations or otherwise treat investors unfairly.* 39

D. Prudently Incurred Cost Has Never Been, and Should Not Now Become, the Constitutional Benchmark. 42

E. The Doctrine of Constitutional Avoidance Has No Application Here. 46

III. THE FCC'S CHOICE OF TELRIC WAS NOT ARBITRARY OR CAPRICIOUS. 47

CONCLUSION 50

TABLE OF AUTHORITIES

Page

CASES

AT&T Corp. v. Iowa Utilities Board, 525 U.S. 366 (1999) ..... *passim*

American Public Gas Ass'n v. FPC, 567 F.2d 1016 (D.C. Cir. 1977) 45

American Trucking Ass'n v. United States, 355 U.S. 141 (1957) 34

Baltimore & Ohio Railroad Co. v. United States, 345 U.S. 146 (1953) 33

Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc., 419 U.S. 281 (1974) 47, 48

Brooks-Scanlon Co. v. Railroad Commission, 251 U.S. 396 (1920) 34

Burlington Northern Railroad Co. v. Surface Transportation Board, 114 F.3d 206 (D.C. Cir. 1997) 19

Center for Auto Safety v. Dole, 828 F.2d 799 (D.C. Cir. 1987) 25

Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) 10, 13

City of Boerne v. Flores, 521 U.S. 507 (1997) 24

City of Los Angeles Department of Airports v. United States Dep't of Transportation, 103 F.3d 1027 (D.C. Cir. 1997) 26

Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987) 17, 18

TABLE OF AUTHORITIES - continued

Page

Corning Glass Works v. Brennan, 417 U.S. 188 (1974) 16

CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) 23

Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989) ..... *passim*

Eastern Enterprises v. Apfel, 524 U.S. 498 (1998) 31, 47

FCC v. Florida Power Corp., 480 U.S. 245 (1987) 41

FCC v. National Citizens Committee for Broadcasting, 436 U.S. 775 (1978) 50

FPC v. Texaco, Inc., 417 U.S. 380 (1974) 22

FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) ..... *passim*

GTE South Inc. v. Morrison, 6 F. Supp. 2d 517 (E.D. Va. 1998), *aff'd*, 199 F.3d 733 (4th Cir. 1999) 16, 31

Illinois Bell Telephone Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993) 33

Indiana Harbor Belt Railroad Co. v. United States, 510 F.2d 644 (7th Cir. 1975) 33

Lincoln Telephone & Telegraph Co. v. FCC, 659 F.2d 1092 (D.C. Cir. 1981) 4

Litton Systems, Inc. v. American Telephone & Telegraph Co., 700 F.2d 785 (2d Cir. 1983) 5

TABLE OF AUTHORITIES - continued

Page

MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977) 4

MCI Telecommunications Corp. v. FCC, 580 F.2d 590 (D.C. Cir 1978) 4

Market Street Railway Co. v. Railroad Commission of California, 324 U.S. 548 (1945) 41, 43

Metropolitan Transportation Authority v. ICC, 792 F.2d 287 (2d Cir. 1986) 33

Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 (1923) 26, 43, 45

Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Cos., 498 U.S. 211 (1991) 22, 43

Olson v. United States, 292 U.S. 246 (1934) 42, 43

Permian Basin Rate Cases, 390 U.S. 747 (1968) ..... *passim*

Potomac Electric Power Co. v. ICC, 744 F.2d 185 (D.C. Cir. 1984) 18

Ruckelshaus v. Monsanto Co., 467 U.S. 986 (1984) ... 36

Smith v. Illinois Bell Telephone Co, 282 U.S. 133 (1930) 34

United States ex rel. Tennessee Valley Authority v. Powelson, 319 U.S. 266 (1943) 43

TABLE OF AUTHORITIES - continued

Page

United States v. American Telephone & Telegraph Co., 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983) 5

United States v. Miller, 317 U.S. 369 (1943) 42

United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985) 11, 47

Williamson County Regional Planning Commission v. Hamilton Bank of Johnson City, 473 U.S. 172 (1985) 31, 47

Wisconsin v. FPC, 373 U.S. 294 (1963) 18, 37, 38, 46

STATUTES

5 U.S.C. § 706 15

47 U.S.C. § 152 4

47 U.S.C. § 251 1

47 U.S.C. § 251(c)(2) 1, 7

47 U.S.C. § 251(c)(3) 1, 7

47 U.S.C. § 251(c)(4) 21

47 U.S.C. § 251(d)(1) 7, 20

47 U.S.C. § 252 7

47 U.S.C. § 252(b)(2)(C) 20

47 U.S.C. § 252(d)(1) 7, 16, 26

47 U.S.C. § 252(d)(1)(A) 16

TABLE OF AUTHORITIES - continued

Page

47 U.S.C. § 252(d)(1)(B) 19, 20

47 U.S.C. § 252(d)(3) 21

47 U.S.C. § 252(e)(6) 27

47 U.S.C. § 253 6

47 U.S.C. § 254 7

47 U.S.C. § 271 1

47 U.S.C. § 271(b)(2) 8

47 U.S.C. § 271(b)(3) 8

47 U.S.C. § 271(c) 8

47 U.S.C. § 272 1

47 U.S.C. § 273 1

47 U.S.C. § 274 1

47 U.S.C. § 275 1

47 U.S.C. § 276 1

Pub. L. No. 104-104, 110 Stat. 56, § 601 7

4 Colo. Code Regs. § 723-30 18

Mich. Comp. Laws § 484.1202(a) 18

Mich. Comp. Laws § 484.2352 18

Mich. Comp. Laws § 484.2357 18

Substantive Rules of the Pub. Util. Comm'n of Tex. § 23.91(f) 19

Tex. Util. Code Ann. § 51.002 18

TABLE OF AUTHORITIES - continued

Page

Tex. Util. Code Ann. § 52.0583 18

Tex. Util. Code Ann. § 52.0584 18

Tex. Util. Code Ann. § 52.204 18

Tex. Util. Code Ann. § 57.022 18

Tex. Util. Code Ann. § 58.055 18

LEGISLATIVE MATERIALS

AT&T Consent Decree: Hearings Before the House Subcomm. on Economic and Commercial Law of the Comm. on the Judiciary, 101st Cong. 749 (Aug. 1-2, 1989) 6

Modified Final Judgment: Hearings on H.R. 1523 Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce, 100th Cong. 32 (July 11, 1991) (statement of Rep. Dan Schaefer) 5

Telecommunications Policy Act (Part 2): Hearings Before the House Subcom. on Telecommunications and Finance of the Comm. on Energy and Commerce, 101st Cong. 42 (May 10, 1990) (statement of Albert H. Kramer) 5

H.R. Conf. Rep. No. 104-458 (1996) 6

ADMINISTRATIVE RULINGS

Coal Rate Guidelines, 1 I.C.C.2d 520 (1985) 17, 49

TABLE OF AUTHORITIES - continued

Page

In re Federal-State Joint Board on Universal Service, Tenth Report and Order, 14 F.C.C.R. 20156 (1999) 28, 29, 30

In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, 11 F.C.C.R. 15499 (1996) ..... *passim*

STATE COMMISSION RULINGS

In re AT&T Communications of New York, Inc., Case 95-C-657, 177 P.U.R. 4th 110, 1997 WL 244288 (N.Y. Pub. Serv. Comm'n Apr. 1, 1997) 29

Consensus Costing Principles/Basis Network Functions; OANAD Cost Methodology Workshop, *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework of Network Architecture Development of Dominant Carrier Networks*, No. R-93-04-003 (Colo. Pub. Util. Comm'n Aug. 23, 1995) 19

In re Determining Costs for Universal Service, Docket No. UT-980311, 1998 WL 1031919 (Wash. Utils. Transp. Comm'n Nov. 20, 1998) 28

In re Determination of the Cost of Basic Local Telecommunications Service, No. 980696-TP, 1999 WL 112536, PSC-99-0068-FOF-TP (Fla. Pub. Serv. Comm'n Jan. 7, 1999) 29

TABLE OF AUTHORITIES - continued

Page

In re Resolution of Petitions To Establish Nondiscriminatory Rates, Terms, and Conditions, Docket No. 950984-TP, Order PSC-96-0811-FOF-TP, 1996 WL 369405 (Fla. Pub. Serv. Comm'n. June 24, 1996) 19

On Its Own Motion Implementation of Section 13-507 of the Public Utilities Act as amended by P.A. 87-856, Docket No. 92-0211, 1994 Ill. PUC LEXIS 333, 155 P.U.R.4th 188 (Ill. Comm. Comm'n Aug. 17, 1994) 18

In re the Investigation into the Cost of Providing Telecommunications Services, UM 351, Order No. 93-1118 (Or. Pub. Serv. Comm'n Aug. 10, 1993) 19

In re On the Commission's Own Motion, To Determine the TSLRIC and Imputation Requirements Under the Michigan Telecommunications Act, Case No. U-11103 (Mich. Comm'n Dec. 12, 1996) .. 18

In re Qwest Corp., No. RPU-00-1, 2001 WL 96396, (Iowa Utils. Bd. Jan. 11, 2001) 29

In re U S West Communications, Inc., 179 P.U.R. 4th 597, 1997 WL 651428 (Idaho Pub. Utils. Comm'n Aug. 12, 1997) 29

MISCELLANEOUS

1999 Statistics of Communications Common Carriers, at Table 2.9 (rel. Aug. 11, 2000), available at http://www.fcc.gov./bureaus/common-carrier/reports/fcc- state_link/socc/99s0cc.pdf. 30

TABLE OF AUTHORITIES - continued

Page

Harvey Avery & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 5 Am. Econ. Rev. 1052 (1962) 45

Affidavit of Edward C. Beauvois, Ph.D (attached to GTE Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) 17

Stephen Breyer, *Regulation and its Reform* (1982) 26

Affidavit of Dr. Robert Crandall (attached to Bell Atlantic Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) 17

Commission of the European Communities, Commission Recommendation on Interconnection in a Liberalised Telecommunications Market, Oct. 15, 1997, http://www.ispo.cec.be/infosoc/telecomplicy/en/r3148-en.htm 9

Communications Daily (May 4, 2001) 12

Ralph Estes, *Dictionary of Accounting* (2d ed. 1985) .. 16

FCC Releases Audit Reports on RBOCs' Property Records, Report No. CC99-3, 1999 WL 95044 (FCC Feb. 25, 1999) 44

http://gullfoss2.fcc.gov/cgi-bin/websql/prod/ccb/armis1/forms/armis.hts 12

http://chart.yahoo.com/d .....

David Gabel & David I. Rosenbaum, *Who's Taking Whom?*, 52 Fed. Comm. L.J. 239 (2000) 18, 19

Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001) 11

TABLE OF AUTHORITIES - continued

Page

Michael K. Kellogg, *et al.*, *Federal Telecommunications Law* (1992) 44

The MIT Dictionary of Modern Economics (4th ed. 1992) 20

Affidavit of Lee L. Selwin and Patricia D. Kravtin (attached to AT&T Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996)) 40

Submission by Ameritech International, Inc. and Bell Atlantic International, Inc. 17

US West, A Framework for Effective Competition 17

BRIEF FOR RESPONDENTS

For the past five decades, regulators, legislators, courts, and competitors have struggled to break open the Bell System's all-encompassing telecommunications monopoly. The Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. §§ 151-276 ("the 1996 Act" or "the Act"), is in many respects the culmination of those efforts. The Act's local competition provisions, 47 U.S.C. §§ 251-254, sought to bring competition to the market for local telephone service – the last bastion of the telephone monopoly, dominated now as then by the former Bell Operating Companies and GTE.[1] Specifically, Congress required these incumbent carriers to interconnect with, and lease unbundled parts of the local network to, competitors at "just and reasonable" rates. 47 U.S.C. §§ 251(c)(2), (c)(3). Concomitantly, the 1996 Act gave the incumbents access to many markets from which they had been previously barred, some immediately and others (such as in-region long distance) upon meeting appropriate conditions. *Id.* §§ 271-276.

While exploiting the enormous benefits the 1996 Act afforded them, and increasing their profits and stock values handsomely as a result, the incumbents have maintained a vigorous rear-guard action in the courts to protect their monopolies over local service. One principal focus of their attack has been the pricing methodologies established by the Federal Communications Commission (the "FCC" or the "Commission") for determining the rates at which the incumbents must make interconnection and unbundled network elements available to new competitors. In accordance with the weight of academic and expert commentary, and following the lead of progressive States that had sought to open their local

---

[1]Through a series of mergers and combinations, the principal incumbents are now Verizon Communications Inc., BellSouth Corporation, SBC Communications Inc., and Qwest Communications International, Inc.

markets even before passage of the 1996 Act, the FCC adopted a forward-looking cost methodology called TELRIC ("Total Element Long-Run Incremental Cost") for setting these rates. The FCC determined that a forward-looking methodology – which determines what it would cost to provide interconnection or an unbundled element efficiently today – was the approach best suited to fostering local competition.

As the incumbents would have it, the FCC's policy choice not only violated the plain terms of the 1996 Act but also constituted a radical and dangerous break with the modern consensus that utility rates must be set on the basis of the historical costs reflected on the utilities' books of account. More jeremiad than legal argument, the incumbents' brief resounds with dire warnings that TELRIC will confiscate billions of dollars of wealth in defiance of the Constitution's guarantee of just compensation.

None of that is true. Putting aside the incumbents' implausible argument that the text of the 1996 Act mandates a historical cost methodology for setting these rates, there is a short and sufficient answer to all of the incumbents' constitutional claims: the incumbents did not present the FCC with a shred of evidence to support them. The claims incumbents make here are instead a pastiche of unsupported extra record assertions, bald conjecture, and self-serving citations to their own submissions in other proceedings – submissions that were often rejected out of hand by the regulatory authorities. Thus, this Court could not accept the incumbents' claims without doing violence to both established Takings jurisprudence (which requires a showing of confiscatory effect and forbids purely methodological challenges) and established administrative law doctrine (which requires those who challenge agency orders to make their case first at the agency). In any event, if this Court were to look beyond the record it would discover in short order why the

incumbents have substituted overheated rhetoric for empirical analysis. In the five years since TELRIC was adopted, new competitors have managed to obtain only 3% of local customers nationwide using unbundled elements. The notion that the FCC "[w]ith a stroke of the regulatory pen" (ILEC Br. at 1) stranded billions of dollars in investment is thus farcical.

If this Court looks beyond these patent deficiencies and considers the incumbents' methodological challenges on the merits, it should reject them. The incumbents can prevail only if this Court overrules *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"), and *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), and holds that the Fifth Amendment requires regulators to use historical cost methods to set utility rates. But *Hope* and *Duquesne* reflect hard-won wisdom about the Court's institutional limitations as an economic policymaker, and they give state and federal authorities needed room to make the practical assessments and pragmatic adjustments that good public policy requires. This Court should not overrule them.

COUNTERSTATEMENT

The 1996 Act and the FCC's implementation of it were not bolts from the blue as the incumbents suggest, but rather were the logical outgrowth of five decades of steady efforts to introduce competition in all markets for telephone service.

A. The Bell System Monopoly and the Onset of Competition

Originally, the incumbents (apart from GTE) were part of the integrated Bell System, which held monopolies on local telephone service throughout the country. The incumbents were affiliated with AT&T, which monopolized the long distance market, and Western Electric, which monopolized the business of manufacturing telecommunications equipment. The Bell System's dominance rested on its control of local

networks. Each local network consisted of lines and switches that connected all homes and businesses in an incumbent's local service area. That network was used to provide local service, but it was also indispensable to long distance service.

Regulatory authority over the telephone system was divided between the federal government (which regulated interstate service) and state governments (which regulated intrastate service). 47 U.S.C. § 152. For years, state governments were generally content to superintend a traditional monopoly rate-of-return regime in local markets. Because local service was thought to be a "natural monopoly," the incumbents were given exclusive franchises, and the rates they charged for service were set by state utility commissions using traditional cost-of-service ratemaking methods. To promote "universal service," the incumbents were permitted to charge highly inflated rates to some customers (chiefly businesses and urban residents) and for some services (such as call-waiting), purportedly because subsidies were needed to provide basic service to high cost (chiefly rural) customers at affordable rates.

The federal government charted a different course. Beginning in the 1960s, the FCC took steps to introduce competition into the markets for customer premises equipment and long distance service.[2] After MCI and other competitors received the right to use the Bell System's local network to initiate and terminate long distance calls (to "interconnect" with the network),[3] competition in the long distance industry began to take hold. Similarly, by the mid-1970s the FCC had rejected AT&T's position that only AT&T customer equipment could

[2] *See MCI Telecommunications Corp. v. FCC*, 561 F.2d 365 (D.C. Cir. 1977).

[3] *See MCI Telecommunications Corp. v. FCC*, 580 F.2d 590 (D.C. Cir 1978); *Lincoln Tel. & Tel. Co. v. FCC*, 659 F.2d 1092 (D.C. Cir. 1981).

be used on AT&T's network, opening the equipment market to competition as well. *See Litton Sys., Inc. v. American Tel. & Tel. Co.*, 700 F.2d 785 (2d Cir. 1983).

The incumbents strenuously resisted the introduction of these forms of competition through a variety of means. That conduct led to the government's antitrust case against AT&T, which was resolved by a 1982 consent decree that divested the incumbents from AT&T. *See United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983). The decree prohibited incumbents from entering the markets for long distance telephone services, equipment manufacturing, information services, and any nonregulated services lest incumbents use their monopoly control over the local network to thwart competition in these related markets. Competition soon flourished in the markets from which the incumbents were barred.

B. The Move Toward Local Competition

These successes led policymakers to question the assumption that local service should be kept immune from competition. Congress held hearings in the late 1980s and early 1990s on proposals to restructure telecommunications markets, emphasizing the need to "rid ourselves of our blind spot to the notion that real competition could never come about in the local exchange arena," and noting that European regulators were already experimenting with local competition.[4]

[4] *Modified Final Judgment: Hearings on H.R. 1523 Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 100th Cong. 32 (July 11, 1991) (statement of Rep. Dan Schaefer); *see also Telecommunications Policy Act (Part 2): Hearings Before the House Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce*, 101st Cong. 42 (May 10, 1990) (statement of Albert H. Kramer) ("The lesson of the last two decades is that

While this policy question was being debated in Congress, several progressive States moved forward with efforts to introduce competition to local markets. Regulators in California, Florida, Michigan, Oregon, and Texas, for example, eliminated monopoly franchises and imposed interconnection and unbundling requirements on incumbents as a matter of state law. *See infra* at 18-19 & nn.12, 14.

C. The 1996 Act

Building on these efforts, Congress sought in the 1996 Act to restructure the telecommunications industry in order to "open[] *all* telecommunications markets to competition." H.R. Conf. Rep. No. 104-458, at 1 (1996) (emphasis added). Congress thus preempted state monopoly franchise laws and similar legal barriers to local competition. 47 U.S.C. § 253. In recognition that the costs of competitive entry were enormous, and following the lead of state commissions, Congress offered three complementary routes to local competition. Under § 251(c), a would-be competitor "can purchase local telephone service at wholesale rates for resale to end users; it can lease elements of the incumbent's network 'on an unbundled basis'; and it can interconnect its own facilities with the incumbent's network." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). Congress also mandated reform of the prior "universal service" system of implicit cross-subsidies, requiring both the FCC (for interstate rates) and the States (for local and other intrastate rates) to ensure affordable service through a system

---

the best way to deliver new services and lower prices to consumers is to break up monopoly power."); *AT&T Consent Decree: Hearings Before the House Subcomm. on Economic and Commercial Law of the Comm. on the Judiciary*, 101st Cong. 749 (Aug. 1-2, 1989) (letter dated August 21, 1989, from Terence Roche Murphy, counsel to British Telecommunications plc) (noting that "the U.K. has sanctioned local loop competition").

of explicit subsidies that is compatible with the introduction of competition. 47 U.S.C. § 254.

The 1996 Act, however, did not express a preference for any particular type of competition. *See In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 F.C.C.R. 15499, ¶ 12 (1996) ("*Local Competition Order*") ("Section 251 neither explicitly nor implicitly expresses a preference for one particular entry strategy.") (JA 271-72). Congress saw that competition had developed in the long distance market through a combination of resale and facilities-based competition, and it was willing to let competitors, rather than legislators or incumbents, determine the best strategy for competition. *See id.* Congress thus "reasonably omitted a facilities-ownership requirement" from the 1996 Act. *AT&T*, 525 U.S. at 392-93.

One critical task Congress delegated to the FCC was the decision of how rates for interconnection and access to unbundled network elements were to be determined. *Id.* at 382-83. The Act simply requires that rates for interconnection and leasing of network elements be "just and reasonable" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)." 47 U.S.C. §§ 251(c)(2), (c)(3), and 252(d)(1). The FCC was charged with implementing these and other requirements of the Act within six months of its passage. *Id.* § 251(d)(1). Once the FCC had established rules, individual state utility commissions would apply them (in light of their superior knowledge of local conditions) to establish "interconnection agreements" between new entrants and incumbents for use of the local network. *Id.* § 252.

The 1996 Act also provided significant benefits to incumbents. Not only did Congress terminate the AT&T consent decree, *see* Pub. L. No. 104-104, 110 Stat. 56, § 601,

it authorized immediate entry by the incumbents into important segments of the long-distance market that had been previously blocked off by the decree. *See, e.g.*, 47 U.S.C. § 271(b)(2) (out-of-region long distance service); *id.* § 271(b)(3) ("incidental interLATA services" such as commercial mobile services (*e.g.*, cellular)). Most importantly, the Act authorized lifting restrictions on the incumbents' provision of in-region long-distance services once the incumbent had satisfied a "competitive checklist." *See id.* § 271(c). Foremost among the checklist requirements are the incumbents' obligations to offer interconnection and nondiscriminatory access to network elements in accordance with the pricing requirements of the local competition provisions.

D. The FCC's Implementation of the 1996 Act

In the *Local Competition Order* issued in August 1996, the FCC concluded that the rates new competitors pay for interconnection and unbundled network elements should be based on "forward-looking long-run economic cost" rather than on "historical" or "embedded" cost. After concluding that the 1996 Act did not dictate the use of any particular methodology, *Local Competition Order* ¶ 705 (JA 398-99), the FCC determined, based on the "substantial weight of economic commentary in the record," that a forward-looking methodology better serves the Act's principal goal of fostering local competition. That was so *not* because a forward-looking methodology would produce lower rates. To the contrary, forward-looking cost "may be higher or lower than historical embedded cost." *Id.* Rather, as the FCC concluded, "a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace." *Id.* ¶ 679 (JA 379-80). Accordingly, such a methodology "will best ensure the efficient investment decisions and competitive entry contemplated by the 1996 Act," *id.* ¶ 705 (JA 398-99), and

should "drive retail prices to their competitive levels." *Id.* ¶ 679 (JA 379-80).

The FCC's approach – called "Total Element Long-Run Incremental Cost" or "TELRIC" – calculates the rate for network elements on the basis of what it would cost to provide the functions the element provides efficiently using up-to-date technology. As the FCC noted, such methods had gained wide acceptance in the professional literature and had been implemented by regulators prior to the 1996 Act both here and abroad. *See id.* ¶ 631 & nn.1508-14 (JA 334-36); *id.* ¶ 681 ("A number of states . . . have already implemented forward-looking incremental costing methodologies to set prices for interconnection and unbundled network elements . . . .") (JA 381).[5] Indeed, several States urged the FCC to adopt a forward-looking cost approach, and none advocated an approach based on historical costs. *Id.* ¶ 671 n.1675 (JA 374).

The FCC also noted that TELRIC – through adjustments in depreciation schedules and the cost of capital – addressed directly the incumbents' concerns that declining technology costs and increased competition could affect the value of their network. *See, e.g.*, *id.* ¶ 686 ("properly designed depreciation schedules should account for expected declines in the value of capital goods" due to "declining technical costs and competitive entry") (JA 384-85); *id.* ¶ 702 ("the overall increases in competition in this industry" "might warrant an increased cost of capital") (JA 395-96). The FCC did not, however, prescribe any particular depreciation schedule or cost of capital. Instead, it left those matters to the States. *See id.* ¶ 29 (JA 273-74).

---

[5] *See* Commission of the European Communities, Commission Recommendation on Interconnection in a Liberalised Telecommunications Market, Oct. 15, 1997, http://www.ispo.cec.be/infosoc/telecompolicy/en/r3148-en.htm (noting that England, Australia, Denmark, and Sweden have adopted forward-looking rates).

The FCC also considered objections to TELRIC based on the Just Compensation Clause of the Fifth Amendment. It noted that if § 251(c)'s interconnection and unbundling requirements were deemed to be a physical occupation of the incumbents' property, TELRIC would be constitutional because TELRIC provides compensation for "the fair market value of the property subject to the taking." *Id.* ¶ 740 (JA 422-23). Alternatively, applying the usual Fifth Amendment test in ratemaking cases, the FCC concluded that TELRIC "should produce rates for monopoly elements and services that approximate what the incumbent LECs would be able to charge if there were a competitive market for such offerings," and that TELRIC thus enabled incumbents "to recover a fair return on their investment." *Id.* ¶ 738 (JA 421-22). The FCC further noted that no incumbent had produced any evidence that TELRIC prices "would have a significant impact on its 'fiscal integrity.'" *Id.* Finally, the FCC concluded that "[t]he record . . . does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at economic costs." *Id.* ¶ 707 (JA 400-01). The FCC made clear, however, that "[i]ncumbent LECs may seek relief . . . if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Id.* ¶ 739 (JA 422).

E. Judicial Review

On review, the Eighth Circuit rejected the incumbents' arguments that the text of § 252(d)(1) of the 1996 Act and the Fifth Amendment required the FCC to use historical costs to set rates for interconnection and unbundled elements. Applying *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Eighth Circuit then held that the FCC's decision to interpret "cost" as meaning "forward-looking cost" was reasonable, because "[f]orward-looking costs have

been recognized as promoting a competitive environment which is one of the stated purposes of the Act." WorldCom Pet. App. 9a-10a. The court also noted that the FCC had "explained in detail" its reason for selecting a forward-looking cost methodology and had sufficiently explained "any past rejection of forward-looking methodologies." *Id.* With respect to the Fifth Amendment, the Eighth Circuit followed this Court's teaching that "a takings claim cannot be based on the ratemaking methodology, but rather it must be based on the rate itself." *Id.* at 13a. Because no "actual rates are established," the court held that it could not determine "whether the impact of TELRIC driven rates will constitute a taking." *Id.* at 13a-14a. Finally, citing *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-29 (1985), the court held that "constitutional avoidance" did not require a different conclusion, because "[t]he possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction," and instead merely "frustrate[s] a potentially permissible application of a statute." WorldCom Pet. App.14a.[6]

F. Local Competition Since the 1996 Act

Despite the efforts of Congress, the FCC, and the States, the incumbents currently control almost 92% of local customers nationwide. *See* Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000*, at Table 1 (May 2001). Moreover, despite the alleged "massive price reductions" (ILEC Br. at 10) resulting from the FCC's TELRIC methodology, only approximately 3% of local phone

---

[6]The Eighth Circuit invalidated one aspect of TELRIC – specifically, the requirement that forward-looking costs be calculated on the basis of the efficient replacement cost of a network element rather than on the cost of the actual network element being used. That ruling is at issue in the related matters of 00-555, 00-587, 00-590, and 00-602.

service is provided using leased unbundled elements. *See id.* at Table 4. The incumbents themselves have been particularly slow to exploit this supposed gold mine. Efforts on their part to compete in each other's local markets are negligible. Meanwhile, long distance authority under § 271 has been granted to incumbents in five States – New York, Texas, Oklahoma, Kansas, and Massachusetts – and more applications are expected soon.[7] Verizon already claims to be the fourth largest long distance company nationwide.

The incumbents have thrived under the 1996 Act. The combined rate of return for their regulated business (state and interstate) has risen from 11.2 percent in 1996 to 16.5 percent in 2000.[8] Their stock value has appreciated substantially, while the value of their principal competitors has stayed flat or eroded.[9] Reality thus refutes the incumbents' unsubstantiated assertions that their investors have suffered "egregious" losses as a result of the FCC's "harsh" regulatory regime. ILEC Br. at 29-30.

---

[7] *See* Communications Daily, at 7 (May 4, 2001) (reporting that Verizon expects to file applications with the FCC to provide long distance service in six States by the end of 2001, with another four in 2002). An application for long distance authority in Connecticut is pending at the FCC.

[8] *See* http://gullfoss2.fcc.gov/cgi-bin/websql/prod/ccb/armis1/forms/armis.hts>> (Report 43-01) (ARMIS data).

[9] Adjusted for splits, BellSouth stock was trading at $19.11 per share on August 8, 1996 (when the FCC released its *Local Competition Order*), and was trading on June 1, 2001, at $40.56 per share. Over the same time period, SBC went from $22.12 to $42.05, and GTE/Verizon went from $25.82 to $54.74. In contrast, Sprint went from $15.68 in August 1996 to $20.96 on June 1, 2001, while AT&T went from $36.39 to $21.49 and WorldCom went from $17.50 to $18.07. *See* <<http://chart.yahoo.com/d>> (providing split-adjusted historical stock data).

SUMMARY OF ARGUMENT

The incumbents' attacks on the FCC's TELRIC methodology lack any merit. Indeed, the incumbents do nothing more than recast as statutory and constitutional claims the failed policy arguments they have been pressing for years before the FCC and state utility commissions.

1. There is no basis in the text, structure, or purposes of the 1996 Act for the incumbents' argument that Congress forbade the FCC from prescribing a forward-looking cost methodology such as TELRIC to calculate the rates new entrants must pay to interconnect with, or lease elements of, the local network. Far from imposing "clear limits" on the FCC's authority, the text of § 252(d)(1) delegates broad methodological leeway. *AT&T*, 525 U.S. at 397. The term "based on . . . cost" has no single fixed meaning, and in the ratemaking context can as easily mean "forward-looking cost" as "historical cost." Indeed, regulators routinely base rates on forward-looking costs, and uniformly did so to implement state market-opening initiatives that presaged the 1996 Act. Section 252's indication that rates "may include a reasonable profit" provides incumbents no support because TELRIC expressly provides for a reasonable profit. Thus, the incumbents have no argument that "Congress has addressed the precise question at issue" and unambiguously foreclosed the FCC's choice of TELRIC. *See Chevron*, 467 U.S. at 843.

2. The Just Compensation Clause of the Fifth Amendment does not bar TELRIC, either directly or as a matter of constitutional avoidance. Since *FPC v. Hope Natural Gas Co.*, the Just Compensation Clause has not bound regulators "to the use of any single formula or combination of formulae in determining rates," and requires only that the end result of applying a rate methodology not be confiscatory. 320 U.S. at 591. Those principles should not be discarded.

Indeed, the FCC's choice of TELRIC should be upheld without any consideration of the incumbents' radical proposal for rewriting Takings law. Even on its own terms, the incumbents' case depends entirely on the factual allegation that TELRIC will result in a massive under-recovery of historical costs still on the incumbents' books. The FCC specifically found, however, that the "record does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements at TELRIC rates," *Local Competition Order* ¶ 707 (JA 400-01), and the incumbents can point to nothing in the record refuting that finding. In all events, the FCC has made clear that an incumbent may seek individualized relief in a separate proceeding if it can demonstrate significant unrecoverable costs. *Id.* ¶ 739 (JA 422). And the incumbents cannot prevail under existing law because they have not shown that TELRIC will impair their ability to "maintain . . . financial integrity, to attract capital, and to compensate its investors for the risk assumed." *Hope*, 326 U.S. at 605. This Court need go no further to dispose of the incumbents' claims.

If this Court considers the incumbents' methodological challenges, it should reject them. The incumbents assert that the Just Compensation Clause forbids a "switch in methodologies unaccompanied by some mechanism to compensate for investment stranded by the shift . . ." ILEC Br. at 27. But there has been no "switch." Rather, Congress imposed, and the FCC implemented, an entirely new set of obligations at the wholesale level to promote competition. In any event, the law forecloses incumbents' argument. *Duquesne* expressly upheld a methodological change that resulted in nonrecovery of prudently incurred costs. 488 U.S. at 315. Such a rule is not needed to protect reasonable investor expectations. No investor has a reasonable expectation that rate-setting methodologies will not change in ways that leave

the investor worse off. And no reasonable investor in the past decade could have believed that the incumbents would remain insulated from competition. Finally, this Court should not make prudently incurred historical costs the sole constitutional standard for rate-setting. That standard is neither more practical nor more fair than available alternatives, including forward-looking methodologies such as TELRIC. A decision to enshrine prudently incurred historical costs would be "as unwarranted as it would be unsettling," *Duquesne*, 488 U.S. at 315, for it would deprive state and federal policymakers of the flexibility needed to "devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Id.* at 313-14 (quotation omitted).

3. The FCC's decision to adopt TELRIC was well "within the bounds of the reasonable," *AT&T*, 525 U.S. at 395, and thus raises no substantial issue under the Administrative Procedure Act. 5 U.S.C. § 706. The *Local Competition Order* contains 244 paragraphs carefully elucidating the FCC's reasoning, and detailing why the FCC declined to adopt the other available options. The FCC likewise persuasively explained why TELRIC would not skew the competitive process or deter competitors from constructing their own facilities where appropriate.

ARGUMENT

I. THE 1996 ACT DOES NOT MANDATE RATES BASED ON THE INCUMBENTS' HISTORICAL COSTS.

Sections 251(c) and 252(d) provide ample authority for the FCC's decision to adopt TELRIC. As previously demonstrated, those provisions contain no mandate that the rates new entrants pay to use the existing local network be based on the incumbents' historical costs. *See* Brief for Petitioners WorldCom, Inc., *et al.* No. 00-555 at 23-27 ("WorldCom Br.").

To the contrary, the 1996 Act delegates to the FCC broad authority to establish a rate-setting methodology that will advance the Act's goal of transforming the monopoly rate-of-return regime for local telephone service into a competitive market. *See AT&T*, 525 U.S. at 397; *id.* at 423 (opinion of Breyer, J.) (Act confers "'broad methodological leeway,'" and "say[s] little about the 'method employed' to determine a particular rate."). Indeed, the only way to grant what the incumbents demand – a guaranteed return on their embedded or historical rate base – would be to engage in the one thing § 252 forbids: a "rate-of-return or other rate-based proceeding." 47 U.S.C. § 252(d)(1)(A). *See GTE South, Inc. v. Morrison*, 6 F. Supp. 2d 517, 529 (E.D. Va. 1998) ("Historical costs are determined in a rate-of-return or other rate based proceeding. . . . Therefore, they are excluded by § 252(d)(1)(A)."), *aff'd*, 199 F.3d 733 (4th Cir. 1999).

Ignoring § 252(d)(1)(A), the incumbents rest their claim for traditional historical cost ratemaking on alternative (and contradictory) readings of the phrase "based on . . . . cost" in § 252(d)(1). They first advance a plain meaning argument, contending that "cost" has a single fixed meaning understood by all to be historical costs. But that argument is not plausible. *See* WorldCom Br. at 25-26; *see also* Ralph Estes, *Dictionary of Accounting* 32 (2d ed. 1985) (term "cost" is "virtually meaningless without an indication of the type of cost, such as incremental cost, variable cost, fixed cost, replacement cost or historical cost"). The incumbents thus beat a quick retreat to the argument that the term "cost" has come to acquire the specialized meaning of "historical cost" in the rate-setting context. Although the incumbents are correct that technical terms should be interpreted "by reference to the art or science to which they [are] appropriate," *Corning Glass Works v. Brennan*, 417 U.S. 188, 201 (1974) (internal citation and

quotation omitted), their assertion that "cost" in this context inevitably means "historical cost" is wrong.

"Historical cost" is one accepted meaning of the term cost in rate-setting, but it is by no means the only accepted meaning. Indeed, incumbents' own experts conceded that the very provision at issue here "does not establish whether the rates for unbundled services and interconnection should be based on actual embedded costs, LRIC, or TSLRIC (total-service long-run incremental cost)," and that "[f]rom an economic standpoint, the pricing of any network function . . . should be based on *long-run incremental cost*."[10] More broadly, regulators often set rates by reference to measures other than historical cost – and the consensus that historical cost methods should not be used is increasing. That point is vividly confirmed by the incumbents themselves, who have "strongly support[ed]" prices for interconnection "based on forward-looking long-run incremental costs" abroad, where they seek to compete in local markets.[11]

At the federal level, the Interstate Commerce Commission and the Surface Transportation Board specifically relied on forward-looking cost measures to set the rates railroads can charge captive shippers. *See Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 (1985); *Consolidated Rail Corp. v. United States*,

---

[10]Affidavit of Dr. Robert Crandall ¶¶ 10, 14 (attached to Bell Atlantic Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) (emphasis added) (JA 84-86); *see also* Affidavit of Edward C. Beauvois, Ph.D, at 2 (attached to GTE Comments, CC Docket No. 96-98 (FCC filed May 16, 1996)) ("[e]conomic theory is absolutely clear that the relevant costs to look at in making pricing decisions are incremental costs") (JA 104).

[11]U S West, A Framework for Effective Competition, at 15; *see also* Submission by Ameritech International, Inc. and Bell Atlantic International, Inc. ¶¶ 1.1-1.2 (endorsing an incremental approach over "historical cost" pricing).

812 F.2d 1444, 1453-57 (3d Cir. 1987); *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 194-95 (D.C. Cir. 1984). The "area rate" method adopted by the Federal Power Commission almost 40 years ago (and repeatedly upheld by this Court) explicitly departed from traditional historical cost methods. *See Wisconsin v. FPC*, 373 U.S. 294, 307-10 (1963). States have likewise turned away from historical cost approaches with increasing frequency.[12]

Ironically, States have been most aggressive about eschewing historical cost methods in precisely the area most relevant here – implementing the state-law precursors to the 1996 Act. States requiring incumbents to unbundle the local network *have uniformly based unbundled element rates on forward-looking, long-run incremental costs*.[13] Thus, for

---

[12]*E.g.*, Rules Prescribing Principles for Costing and Pricing of Regulated Services of Telecommunications Providers, 4 Code of Colorado Regulations § 723-30 (requiring carriers to provide "total service long run incremental cost studies" for both fully regulated services and emerging competitive services); *Implementation of Section 13-507 of the Public Utilities Act, as amended by P.A. 87-856*, Docket No. 92-0211, 155 P.U.R. 4th 188 (Ill. Comm. Comm'n. Aug. 17, 1994) (adopting "long run service incremental cost" methodology for, among others, formerly non-competitive services which have become or are becoming competitive); Mich. Comp. Laws § 484.2202(a) (requiring carriers to measure and report their "total service long run incremental costs"); *see also id.* §§ 484.2352, 484.2357; *In re On the Commission's Own Motion to Determine the TSLRIC and Imputation Requirements Under the Michigan Telecommunications Act*, Case No. U-11103 (Mich. Comm'n Dec. 12, 1996); Tex. Util. Code Ann. §§ 51.002, 52.0583, 52.0584, 52.204, 57.022, 58.055 (mandating the use of long-run incremental cost studies for pricing various competitive services).

[13]Similarly, during the over two–year period in which the FCC's TELRIC rules were not in effect, at least thirty-five state commissions implementing the Act unanimously stated that they were adopting forward-looking cost methodologies that were the same as, or similar to, the FCC's TELRIC methodology. *See* David Gabel & David I. Rosenbaum, *Who's*

example, the consensus cost principles adopted by carriers in California – including the incumbent Pacific Bell – used a total service long-run incremental cost measure. Florida similarly adopted a total service long-run incremental cost measure to price unbundled network elements, as did Oregon, Texas, and Michigan.[14] The incumbents' reading of § 252(d)(1) would therefore result in federal preemption of the state market-opening initiatives on which the 1996 Act was modeled. That cannot be what Congress intended.

The incumbents' remaining statutory construction arguments are makeweights. Specifically, Congress' suggestion that rates "may include a reasonable profit," § 252(d)(1)(B), does not mandate historical cost rate-setting. As the FCC recognized, "[t]he concept of normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.*, the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements." *Local Competition Order* ¶ 700 (JA 393-95); *see also Burlington N. R.R. Co. v. Surface Transp. Bd.*, 114 F.3d 206, 210, 212-14 (D.C. Cir. 1997) (rates based on forward-looking costs of "hypothetical 'stand-alone railroad'" provide "a competitive return on all investments the

---

Taking Whom?, 52 Fed. Comm. L.J. 239, 245 (2000).

[14]*See* Consensus Costing Principles/Basic Network Function; OANAD Cost Methodology Workshops, *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework of Network Architecture Development of Dominant Carrier Networks*, No. R-93-04-003 (Cal. Pub. Utils. Comm'n Aug. 23, 1995); *In re Resolution of Petition(s) to Establish Nondiscriminatory Rates, Terms, and Conditions*, Order, Docket No. 950984-TP, 1996 WL 369405 (Fla. Pub. Serv. Comm'n June 24, 1996); *In re Investigation into the Cost of Providing Telecommunications Services*, UM 351, Order No. 93-1118 (Or. Pub. Util. Comm'n Aug. 10, 1993); *Substantive Rules of the Public Utility Comm'n of Texas* § 23.91(f); *see also supra* at 18 & n.12 (Michigan).

railroad actually made at their current value"). The "cost of obtaining debt and equity financing" is the economic definition of a normal profit. *See Local Competition Order* ¶ 700 (citing *MIT Dictionary of Modern Economics* at 310 (4th ed. 1992)) (JA 393-95). Although the incumbents focus on an accounting measure of profit, § 252(d)(1)(B) is far better read as allowing for "profit" in the sense in which that term is usually used in the rate-setting context – *i.e.*, economic profit. *See MIT Dictionary of Modern Economics* at 350 (definition of profit) (cost of capital is "not included as cost[] in the accountants' measure of profit which therefore does not correspond to this economic definition of profit"). If Congress had intended to require historical cost ratemaking, it could hardly have found a less direct way to do so than by the inclusion of a profit allowance in § 252(d)(1)(B).

Nor can the incumbents find support in § 251(d)(1)'s command that the FCC "complete all actions necessary within six months." As the incumbents would have it, applying an approach such as TELRIC within that time-frame would not be possible, and Congress must therefore have intended that rates be based on historical cost models. That argument suffers from a basic confusion. Congress required that the FCC "establish regulations to implement" the 1996 Act within six months, § 251(d)(1), and the FCC did so. Congress did not, however, mandate application of those regulations to generate specific rates within that time. Indeed, the arbitration process contemplated in § 252 (which takes several months) could not even have commenced until after the regulations were promulgated. 47 U.S.C. § 252(b)(2)(C).

Moreover, the use of historical costs (rather than TELRIC) to set rates under the 1996 Act would have been much more difficult and much more likely to produce delay, for two reasons. First, for more than a decade, the States and the FCC have used price caps – not historical costs – to set the rates the

incumbents may charge. *See* WorldCom Br. at 8. Thus, historical costs are not "already established" (ILEC Br. at 22), and would have to be calculated from scratch. Second, far from being "readily available" (ILEC Br. at 22), the historical costs associated with network elements cannot be ascertained by reviewing the incumbents' books because they do not allocate costs to particular categories of network elements. *See* WorldCom Br. at 36-37 & n.11; *infra* at 44-45. Economic modeling at least as complex as that needed to implement TELRIC would thus be required to determine appropriate allocations of the incumbents' book costs to the individual elements that make up the network. In contrast, the adoption of TELRIC minimized the need for drastic changes by regulators, particularly in States that had already implemented unbundling regimes prior to adoption of the *Local Competition Order*.

Nor do the Act's resale provisions, §§ 251(c)(4) and 252(d)(3), support the incumbents' statutory argument. The incumbents' position is that because Congress allows them to recover their historical costs when they sell services to new entrants at wholesale rates, it must have intended for them to recover their historical costs when they lease network elements. Given that the incumbents elsewhere in their brief complain bitterly that retail rates are often *below* cost, they can hardly argue in this context that the Act's resale provisions (which by definition provide for wholesale rates lower than those retail rates) ensure recovery of their costs.

II. THE JUST COMPENSATION CLAUSE PROVIDES NO REASON TO INVALIDATE THE FCC'S CHOICE OF TELRIC.

The incumbents impermissibly seek to convert a public policy debate over implementation of the 1996 Act into a matter of constitutional principle, and to rewrite constitutional law to enshrine their policy preference. Specifically, they

demand from this Court what they were unable to obtain from Congress, the FCC, and the States: a rule requiring that the rates charged for interconnection and leasing network elements be based on the historical costs on their books of account. The Court has rejected every previous effort in the last six decades to enshrine a particular ratemaking methodology as a constitutional requirement, and it should do so here as well.

A single fundamental premise guides this Court's ratemaking jurisprudence: the Just Compensation Clause does not bind regulators "to the use of any single formula or combination of formulae in determining rates." *Hope*, 320 U.S. at 602; *see also Duquesne*, 488 U.S. at 316 ("the adoption of single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since [*Hope*]"). As the Chief Justice noted in *Duquesne*, ""to declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates."" 488 U.S. at 316 (quoting *Wisconsin v. FPC*, 373 U.S. at 309); *see also Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Cos.*, 498 U.S. 211 (1991); *FPC v. Texaco, Inc.*, 417 U.S. 380, 388 (1974).

Hope and *Duquesne* are grounded in principles of federalism, judicial restraint, and respect for the limits of judicial competence. Recognizing, for example, that "[t]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result," *Duquesne*, 488 U.S. at 314; *see also Permian Basin Rate Cases*, 390 U.S. 747, 790 (1968) ("neither law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders"), these cases ensure that the Court is not entangled in abstract and evolving debates over economic

theory. *See, e.g., CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 92 (1987) ("The Constitution does not require the States to subscribe to any particular economic theory.").

These decisions also acknowledge that politically accountable policymakers (state and federal) are far better suited than are Article III judges to make the judgments necessary for effective ratemaking. The cases thus allow for the "pragmatic adjustments which may be called for by particular circumstances," *Permian Basin Rate Cases*, 390 U.S. at 800, and they give States and federal agencies the necessary freedom to ""devise methods of regulation capable of equitably reconciling diverse and conflicting interests."" *Duquesne*, 488 U.S. at 313-14 (quoting *Permian Basin 390 U.S. at 767*). "[C]ircumstances may favor the use of one ratemaking procedure over another," and the imposition of a rigid constitutional requirement "would unnecessarily foreclose alternatives which could benefit both consumers and investors." *Id.* at 316. For that reason, regulators remain free "within broad limits" to decide "what rate-setting methodology best meets their needs in balancing the interests of the utility and the public." *Id.* So long as the total effect of the rate allows the company "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate investors for the risks assumed," it is constitutional. *Hope,* 320 U.S. at 605; *see also Duquesne*, 488 U.S. at 312.

Against this backdrop, the radical character of the incumbents' position emerges in sharp relief. Although they focus their attack on the FCC's purported "switch" from a historical cost to a forward-looking cost approach, the incumbents' bottom line is that – one way or another – the FCC must compensate them for all prudently incurred costs on their books. That position could not be adopted without overruling *Hope* and *Duquesne*. Each of those cases approved a switch in methodology and explicitly rejected the view that the

Constitution requires a prudent cost methodology or, indeed, any particular methodology, in setting rates.

The incumbents have not remotely made the showing needed to justify such a sharp break with settled law. Indeed, this Court should reject the incumbents' arguments without reaching any fundamental questions of principle because their attack is based on a record entirely devoid of any actual rates, historical costs, or any other relevant evidence on the practical effect of the FCC's TELRIC methodology. Incumbents thus would not prevail even under the standard they propose. Similarly, incumbents cannot prevail under the total effects standard set forth in *Hope* because they have made no showing that the FCC's adoption of TELRIC as a standard for pricing interconnection and leased network elements will threaten their ability to attract capital and operate successfully.

If the Court nevertheless considers the incumbents' attacks on *Hope* and *Duquesne*, it should reject them. As the Court stated unambiguously in *Duquesne*, enshrining historical costs as the constitutional benchmark "would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling." 488 U.S. at 315. State and federal regulators have relied on that unbroken line of precedent in restructuring a host of regulated industries. *See, e.g.*, *City of Boerne v. Flores*, 521 U.S. 507, 536 (1997) ("When the political branches of the Government act against the background of a judicial interpretation of the Constitution already issued, it must be understood that in later cases and controversies the Court will treat its precedents with the respect due them under settled principles, including *stare decisis*, and contrary expectations must be disappointed."). The incumbents' distorted calculus of investor interests and their outdated evaluation of the strengths and weaknesses of competing methodologies provide no basis to depart from *Hope*'s well-worn path.

A. Incumbents' Constitutional Claim Fails on Its Own Terms.

The core of incumbents' Takings claim is that TELRIC will fail to compensate them for all the prudently incurred historical costs associated with the network elements they must lease to new competitors, thereby rendering those costs "stranded" or unrecoverable. According to incumbents, the Fifth Amendment forbids that outcome. As will be shown *infra*, the incumbents' legal position is refuted by a half-century of Takings jurisprudence. But it can and should be rejected for even more basic reasons. As this Court has noted repeatedly, agency ratemaking comes to this Court with a strong presumption of validity, and it is the incumbents' responsibility to put in evidence sufficient to overcome this presumption. *See, e.g.*, *Hope*, 320 U.S. at 602. Moreover, because this case involves review of an FCC administrative proceeding, any evidence on which the incumbents wished to rely had to be submitted to the FCC in the first instance. *See Center for Auto Safety v. Dole*, 828 F.2d 799, 810 (D.C. Cir. 1987) ("The reviewing court may not consider new evidence that was not before the agency when it made its decision.") (citing *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 744 (1985)). The incumbents have utterly failed to satisfy those requirements. In any event, the incumbents could not prevail even under their own theory because TELRIC is accompanied by an administrative "mechanism to compensate"(ILEC Br. at 27) incumbents on an individualized basis if appropriate.

1. There is no basis in the record for the incumbents' Takings arguments.

It is not true as a matter of logic that TELRIC rates for network elements will inevitably be lower than rates based on historical costs. Forward-looking rates can be higher or lower than historical cost rates, as numerous court decisions attest.

See, e.g., *Hope*, 320 U.S. at 596-97; *City of Los Angeles Dep't of Airports v. United States Dep't of Transp.*, 103 F.3d 1027, 1031-32 (D.C. Cir. 1997); *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 299-300 (1923). In theory, there should not be much difference between the two. *See* Stephen Breyer, *Regulation and its Reform*, 37 (1982) (all methods of ratemaking seek to "replicate" the "price, profit, output and efficiency levels that would exist were the regulated market in fact competitive and well-functioning"). Thus, incumbents' claim that TELRIC rates will strand billions of dollars of historical costs is an *empirical* assertion that must be proved. The FCC, however, expressly found that TELRIC prices "may be higher or lower than historical embedded costs," *Local Competition Order* ¶ 705 (JA 398-99), and it determined that the record "does not support the conclusion that significant residual embedded costs will necessarily result from the availability of network elements" at TELRIC rates. *Id.* ¶ 707 (JA 400-01). Nothing in the record calls the reasonableness of that judgment into question.

First, there are no actual TELRIC-generated rates in the record: the incumbents challenge only the FCC's pricing rules, and those rules indisputably do not set rates.[15] State commissions, not the FCC, establish the actual rates new entrants must pay incumbents to lease network elements. 47 U.S.C. § 252(d)(1). In so doing, they set the depreciation schedules and cost of capital, and the FCC has instructed that these inputs take account of the increasing rate of technological change and the increased risks to incumbents in a competitive

[15]The only rates in the record are the now-invalidated "proxy prices," which never took effect and which the FCC stated may not reliably predict TELRIC rates. *See Local Competition Order* (statement of Commissioner Chong) (state commission may "set a specific rate that is *either above or below* the default proxy ceiling or range") (emphasis added) (JA 448).

environment. *See Local Competition Order* ¶¶ 686, 702 (JA 384-85, 395-96). Such adjustments (which increase the rates new entrants must pay) should compensate incumbents for the costs they claim will be stranded. In any event, without actual TELRIC rates to compare to historical costs it is impossible to determine whether TELRIC will "strand" costs.[16]

Second, the record contains no evidence of incumbents' historical costs – much less their prudently incurred costs on an element-by-element basis – even though such evidence is critical to any claim that the FCC's TELRIC rates for particular elements will strand costs. Nor are these costs readily available. Because state and federal regulators have employed price cap regulation for many years, they have not scrutinized the incumbents' costs to determine whether they have been prudently incurred. There is ample reason to believe these book costs are inflated, *see infra* at 44-45, and thus a full-blown inquiry would be necessary to determine the incumbents' prudently incurred costs.

Third, there is no evidence in the record regarding the extent of element leasing by competitors – either actual or predicted. This omission is particularly noteworthy because the available evidence reveals that few competitors have entered local markets in the five years since the FCC issued the *Local Competition Order*, and fewer still have done so by leasing network elements. *See supra* at 11-12. Because they continue to control more than 92% of the market, the incumbents continue to recover the historical costs on their books through the retail rates they charge their customers. By the time

[16]The incumbents have had ample opportunity to prove their theory in concrete settings. The 1996 Act requires state utility commissions to set actual rates using TELRIC, and provides for federal district court review of those rates. § 252(e)(6). In the dozens of federal court challenges brought pursuant to that provision, the incumbents have seldom even raised Takings claims, and have never established any empirical foundation for such claims.

competitors make sufficient inroads using unbundled elements, the incumbents are likely to have recovered the vast majority of the undepreciated historical costs extant in 1996 through those retail rates. Thus, even if TELRIC rates were shown to be lower than historical cost rates, there is no reason to think (and nothing in the record to show) that significant stranded costs would result. That is precisely what the FCC predicted in 1996. *See Local Competition Order* ¶ 688 (JA 385-86).

Incumbents urge this Court to dispense with the usual requirements of proof because "[t]he FCC fully understood that TELRIC rates would be below historical costs"; that, incumbents argue, "was the intent of TELRIC," as well as "its inexorable effect." ILEC Br. at 28; *see also id.* at 39-40. But the *Local Competition Order* expressly reached the opposite conclusion (¶¶ 705, 707 (JA 398-401)), and for good reason. Although some elements of the telephone network – such as switches and other computer-based elements – may have forward-looking costs that are below historical costs, that is not true for many elements. Buildings, land, lines, and poles, for example, whose prices depend primarily on materials or labor rather than technology, often have forward-looking costs above historical costs. *See, e.g., In re Determining Costs for Universal Service*, Docket No. UT-980311, at 41, 1998 WL 1031919, at * 17 (Wash. Utils. Transp. Comm'n Nov. 20, 1998) ("[A]s GTE witness Calnon points out, the current cost of placing a cable is frequently greater than the embedded cost of placing a cable.").

Nor is it true that TELRIC in particular will inevitably result in rates below historical costs. In the universal service context, the FCC's TELRIC model – which calculates federal subsidies to support interstate service in high cost areas – generated rates that are in many cases higher than the incumbents' historical costs. *See In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14

F.C.C.R. 20156, ¶ 27 (1999). Several state commissions have likewise found in arbitration proceedings that the TELRIC rates exceeded the incumbents' historical cost.[17] Indeed, in such proceedings, incumbents have (when it suits their purpose) denied that there is any relevant difference between TELRIC and embedded cost methodologies.[18]

Similarly unpersuasive are the isolated outside-the-record "facts" that incumbents offer up. The incumbents seek to bolster their takings claim by suggesting, for example, that their network cost approximately $342 billion, and that TELRIC's valuation of $180 billion is thus absurdly low. ILEC Br. at 10-11. But the number the incumbents cite is an *undepreciated* number. Using the same data reported by the incumbents, the depreciated book value of the incumbents' network is not $342

---

[17] *In re Qwest Corp.*, No. RPCC-00-1 at 29, 2001 WL 96396, at *14 (Iowa Utils. Bd. Jan. 11, 2001) ("Even Qwest admits its embedded costs are lower than forward-looking in Iowa; a Qwest witness offered testimony the embedded cost of a loop is $17, lower than the statewide average UNE loop price of $20.15."); *In re Determination of the Cost of Basic Local Telecommunications Service*, No. 980696-TP at 10, 1999 WL 112536, at *2 (Fla. Pub. Serv. Comm'n Jan. 7, 1999) (concluding that, in some circumstances, "[t]he embedded cost methodology produces a lower cost for basic local service than the outputs of the models").

[18] *In re AT&T Communications of New York, Inc.*, No. 95-C-657, at 109, 177 P.U.R. 4th 110, 1997 WL 244288 (N.Y. Pub. Serv. Comm'n Apr. 1, 1997) (noting that New York Telephone does not "see any significance in comparisons between TELRIC costs and embedded costs, noting the FCC's explicit recognition that they may differ and that, in some instances, TELRIC costs may be higher than embedded"); *In re U S West Communications, Inc.*, 179 P.U.R. 4th 597, 1997 WL 651428 (Idaho Pub. Utils. Comm'n Aug. 12, 1997) (noting that U S West defended the use of an embedded cost study model by "insist[ing] that the intervenors presented no evidence that forward-looking costs 'differ as a practical matter from the embedded costs used by U S West and Staff'") (quoting U S WEST briefs).

billion but rather $166 billion.[19] Thus, far from showing that TELRIC is confiscatory, the incumbents' own gross figures demonstrate that TELRIC captures the value of incumbents' network. Moreover, even the incumbents' depreciated book value is a number without significance here. It is based on the incumbents' own untested representations of their historical costs and does not even purport to assess what portion of those costs were "prudently incurred." It thus does not correct either for the existence of "phantom assets" that regulators have discovered on incumbents' books or for "gold-plating" that regularly occurred under a rate-of-return regime. Finally, the TELRIC model the incumbents cite is designed for universal service, not for element pricing. The FCC has explicitly stated that the model – which does not include costs for all of the equipment necessary to provide unbundled elements – should not be used "for other purposes, such as determining prices for unbundled network elements," and it has "caution[ed] parties from making any claims in other proceedings based upon the input values [the FCC] adopt[ed]" in developing that model.[20]

Incumbents offer up similar scraps of evidence – such as two self-serving affidavits of GTE marketing employees, *see* ILEC Br. at 10 & nn.4-5 – to suggest that TELRIC rates are 50%-60% of historical cost. *See also id.* at 40 (alleging "massive" discounts). Because the incumbents present their numbers for the first time in this Court, they have not been tested in agency proceedings. Nevertheless, it is noteworthy that one of the affidavits relates to proxy rates, which never took effect, do not constrain the generation of actual TELRIC

---

[19] *See* 1999 Statistics of Communications Common Carriers, at Table 2.9 (Account 350) (rel. Aug. 11, 2000), available at http://www.fcc.gov./bureaus/common-carrier/reports/fcc-state_link/socc/99s0cc.pdf.

[20] *In re Federal-State Joint Board on Universal Service*, Tenth Report and Order, 14 F.C.C.R. 20156, ¶ 32 (1999).

rates, and thus are a red herring, and the other affidavit was drawn from a proceeding in which GTE's own cost model "was labeled a 'black box' because its operation and assumptions could not be tested or effectively challenged by others." *GTE South*, 6 F. Supp. 2d at 527. Moreover, the suggestion that TELRIC rates are always 50% or more below historical cost is belied by the incumbents' own conduct. If TELRIC rates presented the opportunity the incumbents posit, the incumbents themselves would have pounced on that opportunity to lease each other's facilities and compete on each other's home turf. Their failure to do so speaks volumes.

In short, there is no support for the incumbents' central claim that TELRIC will result in massive unrecovered costs.

2. *The FCC's supplemental mechanism to consider stranded cost issues eliminates any Takings concerns.*

Even if the incumbents had shown that TELRIC risked stranding significant investment (and even if that were the relevant constitutional test), the *Local Competition Order* would have to be upheld. The FCC has consistently offered the incumbents an opportunity to prove their stranded costs and seek compensation, *e.g.*, *Local Competition Order* ¶ 739 (JA 422), and the incumbents have consistently failed to take advantage of that opportunity. The Constitution requires no more. *See Permian Basin*, 390 U.S. at 770-71 (rejecting challenge to methodology in part because of a procedure for seeking relief from the order); *Williamson County Reg'l Planning Comm'n v. Hamilton Bank of Johnson City*, 473 U.S. 172, 194 (1985); *see also Eastern Enterprises v. Apfel*, 524 U.S. 498, 545 (1998) (Kennedy, J., concurring) ("The Clause operates as a conditional limitation, permitting the government to do what it wants so long as it pays the charge.").

In *Permian Basin*, the Federal Power Commission ("FPC") set interstate rates using maximum "area rates" rather than

developing individual rates based on each producer's costs. The FPC indicated that it might in exceptional circumstances provide "appropriate relief," including an exception to the maximum rates, if an individual producer could show that its out-of-pocket expenses exceeded its revenues. 390 U.S. at 770-71. The FPC noted, however, that it would not stay enforcement of the area rates pending disposition of the petitions for special relief. The Court of Appeals (previewing incumbents' claim here) held that this escape valve was "inadequate" and "vague," and it ordered the FPC to produce definite guidelines that would allow resolution of the producers claims *before* the general rate order went into effect. *Id.* at 771.

This Court reversed, holding that the FPC "was not obliged to delay area regulation until such guidelines could be properly drawn." *Id.* at 772. The Court also noted that, particularly in light of the "still experimental" nature of the terms and consequences of the FPC's ratemaking approach, the FPC "quite reasonably believed that the terms of any exceptional relief should be developed as its experience with area regulation lengthens." *Id.* at 771-72. The Court specifically refused to hold that "the Commission's broad guarantees of special relief were inadequate or excessively imprecise." *Id.* at 772. Thus, *Permian Basin* makes clear that the incumbents have all the protection to which the Fifth Amendment entitles them.

B. The Incumbents Have Not Shown That the Total Effect of TELRIC Will Be Confiscatory.

Under settled case law, the incumbents could not prevail even if they had shown that TELRIC rates for network elements would strand costs associated with those elements. Such evidence is only the start, not the end, of any takings analysis. Even when there are stranded costs, a rate order is constitutional if the "total effect" of that order allows the company "to operate successfully, to maintain its financial integrity, to attract capital,

and to compensate its investors for the risk assumed." *Hope*, 320 U.S. at 605; *see also Duquesne*, 488 U.S. at 312.

In this case, as in *Duquesne* and *Hope*, the incumbents have not even tried to show that the FCC's actions have threatened incumbents' financial integrity or their ability to attract capital. Nor could they, given the market for incumbents' stock and their profitability. "Silence may sometimes be deafening." *Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1264-65 (D.C. Cir. 1993) (describing failure of incumbent telephone company to submit evidence of any steep decline in share prices to support its contention that FCC rates did not adequately compensate investors).

The incumbents seek to avoid the total effects test by narrowing its scope, contending that the Court must evaluate element leasing as though it were a stand-alone operation. *See* ILEC Br. at 35. That argument, however, is contrary to abundant case law holding that a regulated firm's loss of money on a small segment of its business is not sufficient to demonstrate a taking absent a loss to the firm's "over-all business." *See Baltimore & Ohio R.R. Co. v. United States*, 345 U.S. 146, 148-50 (1953) ("So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.'"); *Metropolitan Transp. Auth. v. ICC*, 792 F.2d 287, 297 (2d Cir. 1986) ("imposing a ceiling on particular rates is not a taking so long as it does not cause the railroad to lose money on its overall business"); *Indiana Harbor Belt R.R. Co. v. United States*, 510 F.2d 644, 650 (7th Cir. 1975) (rejecting Takings claim because plaintiff "did not make the showing as to its over-all operations which was necessary to enable the court to

consider such a claim").[21] Thus, for example, the state commission in *Duquesne* was not barred from considering other regulated revenues even though it allowed no return at all on prudently incurred costs in certain nuclear power plants. And it has never been thought a taking that incumbents must serve high cost rural customers at rates alleged to be below cost, because incumbents were also able to serve low cost customers at inflated rates.

Brooks-Scanlon Co. v. Railroad Commission, 251 U.S. 396 (1920), is not to the contrary. At a minimum, nothing in that decision prohibits including other *regulated* revenues that incumbents receive – including, for example, revenues from access charges and federally-tariffed access facilities; yet the incumbents have offered no evidence to suggest that their revenues on FCC-regulated services – much less their overall regulated revenues – fail to provide a constitutionally adequate return. Moreover, nothing in *Brooks-Scanlon* addresses the present situation, in which the same law that allegedly causes a Taking also makes available substantial new sources of revenue. The same integrated legislative scheme that required the incumbents to lease portions of their networks at "just and reasonable" rates also allowed the incumbents for the first time to enter long distance and other markets that the AT&T consent decree had foreclosed. It would defy common sense and precedent to allow incumbents to challenge a law's alleged burdens without considering its undisputed benefits.[22]

---

[21] *Cf. American Trucking Ass'n v. United States*, 355 U.S. 141, 153-54 (1957) ("economic justification for carrying on a costly peddle operation depends on combining it with a more lucrative truckload operation").

[22] *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930), and related cases are inapposite. They merely directed the separation of rate bases into interstate and intrastate pools pursuant to the divided regulatory authority existing before the 1996 Act. Nothing in those cases prohibits consideration of revenues from retail rates within the interstate jurisdiction. In the approach established by the FCC, it is state regulators that set the cost of capital, the depreciation rate, and other critical inputs to the compensation process. The returns from other state-regulated operations using the same facilities that are the subject of the Act's unbundling requirements thus must be included in any evaluation of the "total effect" of the regulatory scheme.

C. There Has Not Been an Unconstitutional "Switch" in Methodologies.

Having failed to build a record at the agency to demonstrate either that the total effect of the FCC's actions will be confiscatory or even that those actions will result in significant stranded costs, the incumbents propose a new constitutional rule to justify their policy preference: they assert that the Just Compensation Clause limits the ability of regulators to "switch" methodologies. ILEC Br. at 27. Incumbents contend such a rule is needed to shield investors from regulatory changes they might not have anticipated.

This argument is meritless. To begin with, it makes little sense to describe the FCC's choice of TELRIC as a "switch in methodologies" (*id.*) that violated existing expectations. In the 1996 Act, Congress created a new federal right allowing competitors in the local market to lease unbundled network elements from incumbents. The right to lease at TELRIC rates is thus not the result of a shift in the ratemaking formula for the retail rates charged to local customers, but the consequence of an entirely new set of federal rights and obligations at the wholesale level. Additionally, the regulatory regime on which the incumbents' expectations purportedly rest was the old monopoly rate-of-return regime administered by the States. Even with respect to that regime, however, the incumbents nowhere point to any explicit promise by regulators

guaranteeing a return on prudently incurred costs.[23] To the extent that incumbents allege violation of a promise that was implicit, that promise was one made by States, not the FCC. Indeed, prior to the 1996 Act the FCC did not even have jurisdiction over intrastate rates.

The incumbents' argument thus amounts to the following proposition: because *States* implicitly promised that investors would recover prudently incurred costs used to serve *retail* customers, the *FCC* is prohibited from relying on forward-looking costs when it prescribes a method for setting *wholesale* rates for the first time. No case from this Court remotely stands for that remarkable proposition. To the contrary, this Court has repeatedly upheld "switches" in methodologies, including ones that failed to guarantee recovery of costs recoverable under the old regime. Thus no investor could have reasonably believed that federal regulators had guaranteed a return under the regulatory framework in effect at the time of investment. Any doubt should have been conclusively dispelled by the progression from monopoly to competition that had occurred in the telecommunications industry over the past fifty years and that had been signaled for local markets for a decade or more.

1. Nothing in this Court's jurisprudence precludes or limits a one-time switch in methodologies.

Even if the FCC's adoption of TELRIC were considered a "switch," there is no support in this Court's jurisprudence for the proposition that the Just Compensation Clause forbids regulators from switching methodologies whenever the switch

---

[23]The absence of any explicit promise alone is sufficient to defeat any "regulatory compact" claim. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1010-11 (1984). That is perhaps why the incumbents allude to, but decline to rely on, this Court's regulatory compact cases. *See* ILEC Br. at 30.

would deny full recovery of costs identified under the previous methodology. To the contrary, fundamental changes in rate-setting methodology have routinely been upheld without any special scrutiny.

In *Wisconsin v. FPC*, the FPC declared its intention to switch from an "individual company cost of service method, based on theories of original cost and prudent investment" to an approach under which rates would be established "on an area basis, rather than on an individual company basis." 373 U.S. at 298-99. As a result, individual producers with above-average costs might not recover all their costs. This Court nevertheless rejected efforts – much like the ones incumbents have made here – to invalidate that switch even before rates were set, noting that "we cannot say that the rates to be developed in these proceedings will in all likelihood be so high as to deprive consumers, or so low as to deprive producers, of their right to a just and reasonable rate." *Id.* at 310.

In *Permian Basin*, natural gas producers brought a similar constitutional challenge to the same "area rate approach" after the area rates were set. The FPC's implementation of the area rate approach included a safety valve that ensured recovery of certain "operating expenses"; the FPC explicitly noted, however, that a producer's inability to recover its "unsuccessful exploration costs" – even if prudently incurred – would not alone warrant relief. Despite this clear indication that individual producers might not recover all historical costs or even all prudently incurred costs (as they would have under the old regime), the Court upheld the rate order in its entirety.

And in *Duquesne*, this Court upheld a Pennsylvania statute that switched methodologies to preclude the recovery of investments that were not used and useful, even though those investments had been prudently incurred and would have been recoverable under the old regime. Indeed, since *Hope*, this

Court has *never* struck down a rate or ratemaking methodology on the ground that it was a switch from a prior methodology.

Remarkably, the incumbents purport to rely on *Duquesne*. But *Duquesne* quite clearly held that a regulator has considerable freedom to switch rate-setting methodologies even if the switch would "strand" costs recovered under the previous approach. *Duquesne* was quite careful to note (in limited *dicta*) that it is not a single switch, but only a decision "to *arbitrarily* switch back and forth between methodologies" that even arguably raises "constitutional questions." *Wisconsin v. FPC*, 373 U.S. at 315 (emphasis added). *Duquesne*'s focus on arbitrariness was no accident. Arbitrarily switching back and forth between methodologies gives rise to the concern that rates are being set opportunistically to the detriment of utilities (without any valid public policy basis), forcing them to "bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Id.* But it is a far different manner when regulators change methods in pursuit of legitimate public policy objectives, or based on practical assessments of the relative merits of one regulatory tool over another. *See, e.g., id.* at 298-99 (switching methodologies because the old methodology "gave rise to staggering cost allocation problems," resulted in "widely varying prices for gas from a single field," and created an "intolerable administrative burden"). To view with hostility any change in methodologies would be to deprive state and federal policymakers of the flexibility *Duquesne* specifically sought to preserve.

Nor are the incumbents helped by the observation in *Duquesne* that the rates set by the Pennsylvania PUC provided an adequate return even under the old rate base. The Court never suggested that this comparison, which was essentially a "sanity check" on the new approach, was a constitutional requirement. Indeed, such a conclusion would be flatly contrary to the remainder of the opinion, which not only limited

constitutional concerns to situations in which regulators *arbitrarily* switch back and forth, but also emphasized the methodological freedom possessed by regulators and refused to enshrine prudently incurred costs as a constitutional baseline.

The instant case illustrates the wisdom of *Duquesne*. The FCC adopted TELRIC because it was the methodology best suited to advancing the 1996 Act's goal of bringing competition to local markets, and because there was no reason to think it would have harsh results. Although rapid technological change has driven down the forward-looking cost of computer-based elements, elements whose cost depends on labor and materials are generally more expensive than they used to be. *See Local Competition Order* ¶ 705 (JA 398-99). There is thus no reason to deny the FCC the option of using TELRIC. Moreover, regulatory flexibility is particularly critical in telecommunications, where methods of competition, modes of communication, and whole sectors of the industry exist today that were unimaginable decades earlier. Congress, state regulators, and the FCC have always had, and must continue to have, discretion – except "at the margins" – to adapt to those changes. Nothing in Constitution requires a different result.

2. *The "shift" in methodologies did not upset reasonable investor expectations or otherwise treat investors unfairly.*

Even if all that were not so, the underpinning for the incumbents' proposed bar on methodological change – that it is unfair to investors – lacks merit. According to incumbents, the FCC's "abrupt shift" to TELRIC surprised reasonable investors, effectively "rewriting the terms of thousands of regulatory transactions closed long ago," and "eliminat[ing] the basis on which private parties have relied in making substantial investment." ILEC Br. at 29-30.

In truth, the 1996 Act was a surprise to no one. States had been trying to introduce competition to local markets for years by requiring unbundling at rates based on forward-looking costs. With the former monopolistic long distance and equipment markets fully open to competition and the consensus building to open local markets, no reasonable investor could have expected that the FCC or the state commissions would guarantee recovery of all prudently incurred costs.

Similarly belied by the record is the suggestion that the 1996 Act rewrote transactions "closed long ago." ILEC Br. at 30. At the time of the FCC proceedings, over 50% of the incumbents' plant had been acquired in the 1990s, when no reasonable investor could have believed that the local monopoly would be forever sheltered from competition, *see* Affidavit of Lee L. Selwin and Patricia D. Kravtin, ¶ 5 (attached to AT&T Reply Comments, CC Docket No. 96-98 (FCC filed May 30, 1996)) (JA 149-51), *see also*, Supp. Lodging, and incumbents were replacing older plant at the rate of 5-10% per year. *Id.* The vast majority of incumbents' investment, therefore, occurred when an expectation of guaranteed recovery of all prudently incurred costs was patently unreasonable.

The terms of the 1996 Act further refute any claims of unfairness to investors. The FCC's adoption of TELRIC occurred as part of a broader reallocation of benefits and burdens that occurred as part of the 1996 Act. The Act relieved the incumbents of the various consent decrees to which they were subject and opened vast new markets – such as the long distance markets – that incumbents have entered aggressively. *See supra* at 7-8, 12. Equally critical are the benefits bestowed by the local competition provisions themselves, which permit incumbents, as potential competitors in local markets outside their home regions, to benefit from the same "unconstitutional" rate regime of which they complain. In assessing the 1996

Act's effect on investor expectations, these many benefits cannot be ignored.

More broadly, absent an explicit promise that incumbents nowhere assert, investors could not have expected that they would be immune from regulatory change or the introduction of competition. This Court has consistently rejected the notion that investors have a constitutional right to a guaranteed return on historical costs. *See, e.g.*, *Market Street Ry. Co. v. Railroad Comm'n*, 324 U.S. 548, 566 (1945) ("[R]egulation does not assure that the regulated business make a profit."); *Hope*, 320 U.S. at 603 ("[R]egulation does not insure that the business shall produce net revenues.") (internal citation and quotation omitted). Instead, regulated entities have a right only to a rate that ensures their fiscal integrity and allows them to attract capital, and investors can reasonably expect no more.

Finally, incumbents' arguments suffer from a more fundamental failing: if investors' expectations of guaranteed return on investment have been upset, it is the decision to introduce competition, not the FCC's pricing decisions, that has upset them. A firm facing competition surely has no guarantee that it will recover its historical costs. If incumbents are correct that investors reasonably expected a guaranteed return on their investment, then the introduction of competition itself violates the Constitution. Given that the interests of investors have never been the sole concern of the Just Compensation Clause, *see, e.g. Hope*, 320 U.S. at 603 (fixing rates "involves a balancing of the investor and the consumer interests"); *FCC v. Florida Power Corp.*, 480 U.S. 245, 253 (1987) ("investors' interests provide only one of the variables in the constitutional calculus of reasonableness") (internal citation and quotation omitted), this Court should hesitate before embracing such a significant limitation on state and congressional power to experiment with deregulation.

D. Prudently Incurred Cost Has Never Been, and Should Not Now Become, the Constitutional Benchmark.

Because their other arguments lack merit, the incumbents ultimately can prevail only if this Court does what it has refused to do for more than a Century: enshrine the prudent cost methodology as a constitutional requirement. Although the incumbents' failure to present evidence renders this issue purely academic (*see* Point II.A), the imposition of prudently incurred cost as the constitutional standard would be entirely "unwarranted." *Duquesne*, 488 U.S. at 315. In every other area of Takings law, it is value, not historical cost or prudently incurred cost, that is the constitutional touchstone. Thus, a methodology that gives the incumbents the value of the elements leased – which TELRIC surely does[24] – is constitutional. And incumbents' principal arguments for a prudent cost approach – that it is less manipulable and more practical – are myths.

Elevating prudently incurred costs to the status of a constitutional benchmark would effect a radical restructuring of Takings law, placing investors in public utilities in a privileged position occupied by no other property owners. It is settled outside of ratemaking that the owner of property is entitled only to "the market value" of the property at the time of the Taking, *Olson v. United States*, 292 U.S. 246, 255 (1934); *see also United States v. Miller*, 317 U.S. 369, 374 (1943), even if that value is less than the owner's investment in the property, *see* 292 U.S. at 255 (market value "may be more or less than the

[24] Forward-looking cost methodologies such as TELRIC are accepted methods for valuing property. In a competitive market, a buyer would never pay more for an asset than the cost of building a functional substitute for it. By measuring what it costs now to replace the functionality of the existing network, TELRIC "mimics the operation of the competitive market," *Duquesne*, 488 U.S. at 308, and thus captures the full value of that network.

owner's investment," and the "return yielded may have been greater or less than interest, taxes, and other carrying charges"). The Fifth Amendment "does not guarantee [a property owner] a return of his investment," *United States ex rel. Tennessee Valley Authority v. Powelson*, 319 U.S. 266, 285 (1943), because "[i]t is the property and not the cost of it that is safeguarded by state and Federal Constitutions." *Olson*, 292 U.S. at 255.

Until now, this Court has consistently reaffirmed that, in ratemaking cases, the Constitution does not require recovery of historical cost, or even recovery of prudently incurred cost, and that compensation based on the value of the assets is permissible. *See Duquesne*, 488 U.S. at 308 (*quoting Smyth v. Ames*, 169 U.S. 466, 547 (1898)). Indeed, prior to *Hope*, the Court consistently rejected efforts to allow regulators to use historical costs as the sole measure of constitutionally adequate compensation. *See, e.g., Southwestern Bell Tel. Co.*, 262 U.S. at 289-90 (Brandeis, J. concurring); *see generally Duquesne*, 488 U.S. at 308-09.

Since *Hope*, this Court has repeatedly approved methodologies that measure the value of the assets, *see, e.g., Duquesne* 308-09 (approving a methodology under which "[t]o the extent utilities' investments turn out to be bad ones, . . . the investments have no fair value and so justify no return); *Market Street Ry.*, 324 U.S. at 564-67 (affirming rates based on present value of company's assets and thus affirming write off of more than *two-thirds* of company's historical investments); *Mobil Oil*, 498 U.S. at 219 (affirming approach that "approximated the replacement cost of gas based upon the current cost of finding new gas fields, drilling new wells, and producing new gas"), and has approved methodologies that explicitly declined to cover the prudently incurred costs of property-owners. *See Permian Basin*, 390 U.S. at 769-71 (approving area rate methodology designed to meet the average costs rather than

individual costs and that explicitly refused to provide recovery for unsuccessful exploration costs, even if prudently incurred).

The case for enshrining prudent cost as the constitutional standard is startlingly weak. Incumbents suggest first that prudential cost methodologies are less manipulable than forward-looking value-based methodologies. Accurate historical costs of even the total network, however, cannot simply be read from a book or easily and objectively determined. *See* Michael K. Kellogg, *et al.*, *Federal Telecommunications Law* § 9.8, at 477 (1992) ("We now know that by the early 1980s the Bell System had accumulated a vast library of accounting books that belonged alongside dime-store novels and other works of fiction."). Indeed, an FCC audit found that incumbents' books, which would be the basis for historical cost analysis, are filled with "phantom assets" whose existence cannot be verified. *See, e.g.*, *FCC Releases Audit Reports on RBOCs' Property Records*, Report No. CC99-3, 1999 WL 95044 (FCC Feb. 25, 1999) (FCC audit comparing book entries for $47 billion in assets with actual assets revealed that incumbents' "book costs may be overstated by approximately $5 billion"). As Justice Jackson observed, "[t]o make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates. . . . However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive." *Hope*, 320 U.S. at 644 n.40 (Jackson, J., dissenting).

Nor is the assessment whether costs have been prudently incurred a simple one. The traditional regime of monopoly rate-of-return regulation created substantial incentives for incumbents to overinvest in, or "gold-plate" their networks by building facilities not needed to provide local service. *See* Kellogg, *supra*, at 478. Although regulators scrutinize

incumbents' investments, overinvestment is frequently impossible to pinpoint. *See* Harvey Averch & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 5 Am. Econ. Rev. 1052, 1062-63 (1962). Moreover, even if prudently incurred costs could be determined, there is no way other than through economic modeling to assign those costs to particular elements in particular locations because the incumbents' books are not kept on an element-by-element basis. There is no reason to believe that this allocation process is any more objective or less difficult in a prudent cost regime than it is in a forward-looking cost regime. A forward-looking cost approach has the advantage that the starting point for the cost allocations are open for all parties to review.

Nor can any practical problems of calculating the value of utility property justify imposition of a prudent cost rule as a requirement of the Constitution or preclude reliance on a TELRIC methodology. Advances in economic modeling, now a routine aspect of rate regulation, permit the measurement of forward-looking costs with unprecedented accuracy. *See generally American Pub. Gas Ass'n v. FPC*, 567 F.2d 1016, 1036-37 (D.C. Cir. 1977). That is why, by 1996, forward-looking methodologies such as TELRIC were being used successfully by state regulators and by regulators abroad in analogous contexts, *see Local Competition Order* ¶ 631 (JA 334); *supra* at 5-6, 17-19; *Duquesne*, 488 U.S. at 316 n.10, and that is why at least 35 States independently adopted TELRIC (or similar) methodologies during the two-year period in which the FCC's TELRIC rules were stayed. *See supra* at 18 n.13.

Further, the history of this Court's ratemaking jurisprudence teaches that the alleged impracticality of one approach provides a shaky foundation for establishing another as the fixed constitutional standard. *Cf. Southwestern Bell Tel. Co.*, 262 U.S. at 309 (Brandeis, J., concurring) (noting a historical cost approach, which was "impossible" thirty years

earlier, had become "feasible"). As TELRIC itself demonstrates, refinements in economic modeling and advances in computing have made practical today what may have seemed impractical in 1923. Concerns over impracticality, while relevant policy considerations, do not justify enshrining one methodology as required (or forbidden) by the Constitution.

E. The Doctrine of Constitutional Avoidance Has No Application Here.

The incumbents' arguments fare no better dressed up in the garb of constitutional avoidance. That doctrine has extremely limited application in Just Compensation cases generally, and has no application here.

Hope and *Duquesne* foreclose the argument that a regulator lacks flexibility to choose a particular ratemaking methodology on the basis of a speculative assertion that the methodology might result in confiscatory rates. The proposition that the Constitution does not impose any particular methodology would be meaningless if the mere allegation that a particular methodology (or switch in methodologies) might raise a Takings claim would prohibit the use of that method. The incumbents' argument is also irreconcilable with the Court's refusal to use analogous avoidance arguments to construe the term "just and reasonable" to require a particular methodology, even following a "switch" that did not guarantee recovery of costs. *See, e.g., Wisconsin v. FPC*, 373 U.S. at 309.

Riverside Bayview similarly refutes incumbents' argument. In that case, the Court rejected a Takings-based avoidance claim, holding that "the possibility that the application of a regulatory program may in some instances result in the taking of individual pieces of property is no justification for the use of narrowing constructions to curtail the program if compensation will in any event be available in those cases where a Taking has occurred. Under such circumstances, adoption of a narrowing

construction does not constitute avoidance of a constitutional difficulty; it merely frustrates permissible applications of a statute or regulation." 474 U.S. at 128 (internal citation and quotation omitted).

The doctrine of constitutional avoidance must be sparingly applied in the takings context, because the Just Compensation Clause "is designed not to limit the governmental interference with property rights per se, but rather to secure compensation in the event of otherwise proper interference amounting to a taking." *Eastern Enters.*, 524 U.S. at 545 (Kennedy, J., concurring) (internal citation and quotation omitted); *see also Williamson County*, 473 U.S. at 193. Aggressive application of the doctrine would effectively prohibit government action even though the Clause itself would undoubtedly permit that action as long as a payment mechanism is available. Here, such a mechanism is available at the FCC. *See supra* at 10, 31.

III. THE FCC'S CHOICE OF TELRIC WAS NOT ARBITRARY OR CAPRICIOUS.

Lacking any serious textual or constitutional argument, the incumbent LECs close with a smorgasbord of administrative law challenges to the reasonableness of the FCC's decision to adopt TELRIC. In assessing these claims, the relevant inquiry is not whether this Court would have reached the same judgment had it decided the issue in the first instance, because a reviewing court "is not empowered to substitute its judgment for that of the agency." *Bowman Transportation, Inc. v. Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 285 (1974) (internal citation and quotation omitted). That is particularly true where, as here, the matter is at the heart of the agency's technical expertise and requires predictive judgments. If the agency has "drawn out and crystalized [the] competing interests [presented and] attempted to judge them with as much delicacy as the prospective nature of the inquiry permits, . . . [the court]

can require no more." *Id.* at 293-94 (quotation omitted). The *Local Competition Order* contains no "clear error of judgment," *id.* at 285, and thus easily survives review.

The incumbents first assert that TELRIC was an arbitrary policy choice because it amounted to an unexplained departure from the FCC's prior consistent commitment to historical cost rate-setting. That charge is baseless. The FCC had departed from historical cost methods more than a decade before when it introduced price caps based on the perceived shortcomings of historical cost ratemaking. *See* WorldCom Br. at 8. Moreover, the FCC could not have departed from prior policy in implementing §§ 251 and 252 because the *Local Competition Order* was the FCC's first word on the subject. The *Order* addressed a new issue on which the FCC had never previously spoken. That the FCC had used historical cost ratemaking to implement the pricing provisions of the 1992 Cable Act is beside the point. That was an entirely different statute addressing an entirely different market that remained in a monopoly state.

Nor can the FCC credibly be faulted for failing to explain its choice of TELRIC over competing options presented to it. A full 244 paragraphs of the *Local Competition Order* are devoted to justifying the choice of TELRIC and, in particular, to explaining why it best implements the 1996 Act's goal of opening local markets to competition. *Local Competition Order* ¶ 679 (JA 379-80). The *Order* expressly considers and rejects all alternative pricing approaches proposed in the comments. Thus, for example, the FCC rejected a "replication cost" approach on the ground that it would distort the rates consumers pay for telephone service. *See id.* ¶ 684 (JA 383). The FCC likewise rejected a historical cost methodology on the grounds that it would reward past incumbent inefficiency, send the wrong price signals to new entrants, and deny consumers the benefits of competition-based rates. *Id.* ¶¶ 704-711 (JA 397-

403). And the FCC rejected the "efficient component pricing" method ("ECPR") on the grounds that it would (by granting incumbents the full measure of profit they would otherwise lose to competition) inappropriately inflate costs borne by new entrants. *Id.* ¶¶ 708-711 (JA 401-03); *see also id.* ¶ 662 (JA 368) (discussing comments of Professors Baumol, Ordover, and Willig). The FCC rejected "Ramsey pricing" on the ground that it was particularly ill-suited to the goals of the 1996 Act, *id.* ¶ 696 & n.1700 (JA 390-91), concluding, as have other federal regulators, that the use of Ramsey pricing is also "too difficult and burdensome for universal application" because it requires "the elasticity of demand to be quantified" for every element that will be priced. *See Coal Rate Guidelines*, 1 I.C.C.2d at 527.

Nor was there anything remotely inadequate about the Commission's explanations. The Commission considered and rejected the incumbents' assertion that a forward-looking cost methodology is difficult to administer – based on the experiences of States that had already employed such approaches. *Local Competition Order* ¶¶ 631, 681 (JA 334-36, 381). That judgment is bolstered by the recent experience of States which have, in fact, set rates based on the forward-looking cost models introduced by new entrants and incumbents alike. The FCC's conclusion that the use of historical costs would lead to compensation for significant levels of incumbent inefficiency is equally reasonable. Although regulators *once* tried to scrutinize incumbents' books to determine if their costs were prudently incurred, that enterprise proved so difficult that regulators have generally abandoned that effort and moved to price cap regulation.

The incumbents also find fault with the FCC's conclusion that non-TELRIC prices will lead to inefficient investment decisions. ILEC Br. at 48-49. But the FCC merely indicated, consistent with the weight of economic authority, that even

rational, efficient actors will make choices based on the data and circumstances presented to them. If input costs are not priced at forward-looking, efficient rates, the decisions entrants make will be similarly inefficient. *Local Competition Order* ¶¶ 672, 679, 705 (JA 375, 379, 398). The FCC's decision to encourage efficient investment decisions is plainly rational.

Finally, the incumbents assert that the "FCC ignored the threat" that prices which are set "too low" will discourage facilities-based competition. ILEC Br. at 49. That assertion is simply false. The FCC expressly acknowledged this theoretical possibility, and adjusted its methodology to inflate rates in order to further *encourage* facilities-based entry. *Local Competition Order* ¶ 685 (concluding that building existing inefficiencies into TELRIC would "encourage[] facilities-based competition to the extent that new entrants, by designing more efficient network configurations, are able to provide the service at a lower cost than the incumbent") (JA 383-84). The FCC's conclusion that the particular methodology it adopted best serves the dual policy goals of providing consumers the benefits of competition and encouraging efficient facilities-based entry epitomizes the "rational weighing of competing policies" to which deference is owed. *FCC v. National Citizens Comm. for Broad.*, 436 U.S. 775, 803 (1978).[25]

CONCLUSION

The Eighth Circuit's holding that neither the 1996 Act nor the Constitution prohibits the use of TELRIC's forward-looking methodology should be affirmed.

---

[25]The incumbents promise to explain in their response brief their argument that TELRIC incorporates "unrealistic projections." ILEC Br. at 48. WorldCom will thus address that argument in its reply brief. The incumbents also assert that the equities preclude the use of TELRIC because investors assumed that rates would be based on historical cost. *Id.* at 49. As explained, *see supra* at 39-41, that assertion is baseless.

Respectfully submitted,

THOMAS F. O'NEIL III
WILLIAM SINGLE, IV
WORLDCOM, INC.
1133 19th Street, N.W.
Washington, D.C. 20036
(202) 736-6096

DONALD B. VERRILLI, JR.
Counsel of Record
JODIE L. KELLEY
IAN HEATH GERSHENGORN
JENNER & BLOCK, LLC
601 13th Street, N.W.
Washington, D.C. 20005
(202) 639-6000

Counsel for Respondent WorldCom, Inc.

JONATHAN M. ASKIN
THE ASSOCIATION FOR
LOCAL TELECOMMUNICATIONS SERVICES
888 17th Street, N.W.; Suite 900
Washington, D.C. 20006
(202) 969-2597

Counsel for Respondent the Association for Local Telecommunications Services

CAROL ANN BISCHOFF
ROBERT M. MCDOWELL
COMPETITIVE TELE-
COMMUNICATIONS
ASSOCIATION
1900 M Street, N.W.
Washington, DC 20036
(202) 296-6650

ROBERT J. AAMOTH
KELLEY DRYE &
WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Counsel for Respondent Competitive Telecommunications Association

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
JUL 23 2001
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Respondents.

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND
UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF ON THE MERITS OF SPRINT CORPORATION IN SUPPORT OF PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

25 pp

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
PRELIMINARY STATEMENT	1
ARGUMENT	1
I. THE FCC's SELECTION OF A PRICING METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST DOES NOT VIOLATE THE ACT	1
A. The Telecommunications Act Of 1996 Does Not Mandate Recovery Of Historical Costs	1
B. The FCC's Selection Of A Cost Methodology Based On The Most Efficient Replacement Technology Was Reasonable And Rule 505(b)(1) Should Be Reinstated...	5
1. Rule 505(b)(1) Simulates The Real World Costs To A New Entrant In A Competitive Environment	5
2. Rule 505(b)(1) Encourages Facilities-Based Competition	8
3. The FCC's Cost Methodology Fairly Compensates ILECs For The Costs Of Providing UNEs	9
C. Rule 505(b)(1) Does Not Raise "Serious Constitutional Questions" Of A Takings Violation	11
II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS DOES NOT VIOLATE SECTION 251(c)(3) OF THE ACT	12

TABLE OF CONTENTS—Continued

	Page
A. Section 251(c)(3) Is Ambiguous	12
B. The UNE Combinations Rule Is Reasonable And Necessary To Ensure Meaningful UNE Access	15
C. Review Of The Combinations Rule Was Not Waived	19
CONCLUSION	20

TABLE OF AUTHORITIES

CASES	Page
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry., 387 U.S. 397 (1967)	12
Capital Network Sys., Inc. v. FCC, 28 F.3d 201 (D.C. Cir. 1994)	3
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	6
Communist Party of the United States v. Subversive Activities Control Bd., 367 U.S. 1 (1961)	19, 20
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944)	3
GTE Serv. Corp. v. FCC, 205 F.3d 416 (D.C. Cir. 2000)	18, 19
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	14
Iowa Utils. Bd. v. FCC, Nos. 96-3321 *et al.*, Order (8th Cir. June 10, 1999)	19
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	2, 3, 19
New York Cent. R.R. v. White, 243 U.S. 188 (1917)	12
Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc., No. 97-D-CA-132, 1998 U.S. Dist. LEXIS 15,637 (W.D. Tex. Aug. 31, 1998)	7
Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118 (1939)	12
U S W. Communications, Inc. v. Jennings, 46 F. Supp. 2d 1004 (D. Ariz. 1999)	7

TABLE OF AUTHORITIES—Continued

Page

Verizon Communications, Inc. v. FCC, 121 S. Ct. 877 (2001) 19

STATUTES

47 U.S.C. § 251(c)(2)(C) 14
47 U.S.C. § 251(c)(3) ..... *passim*
47 U.S.C. § 251(c)(6) 18
47 U.S.C. § 251(d)(2) 16, 18
47 U.S.C. § 251(d)(1)(B) ..... *passim*
47 U.S.C. § 251(d)(2) ..... *passim*

AGENCY DECISIONS

Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996) ..... *passim*
Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, 15 F.C.C.R. 3696 (1999) 14, 15

RULES

Sup. Ct. R. 19.4 19
47 C.F.R. § 51.315(b) (2001) ..... *passim*
47 C.F.R. § 51.315(c)-(f) (2001) ..... *passim*
47 C.F.R. § 51.319 (2001) 17
47 C.F.R. § 51.505(b)(1) (2001) ..... *passim*

CONGRESSIONAL MATERIAL

S. Rep. No. 104-23 (1995) 4

OTHER AUTHORITY

Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (1st ed. 1992) 6

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.4 and 25.3, Respondent Sprint Corporation ("Sprint") respectfully submits this Reply Brief on the Merits of Sprint Corporation in Support of Petitioners Federal Communications Commission ("FCC") and the United States of America.[1]

ARGUMENT

I. THE FCC's SELECTION OF A PRICING METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST DOES NOT VIOLATE THE ACT.

A. The Telecommunications Act Of 1996 Does Not Mandate Recovery Of Historical Costs.

The ILECs generally repeat the same arguments made in their petitioners' brief in challenging the FCC's "most efficient replacement cost" methodology ("Rule 505(b)(1)") for pricing network elements ("UNEs") under the Telecommunications Act of 1996 ("Act"). The ILECs claim that the Act's wholesale pricing provision and the term "reasonable profit" in Section 252(d)(1)(B) demonstrate that historical costs are required; accordingly, they argue, the FCC's forward-looking "most efficient replacement cost" methodology is unlawful because it does not provide for their historical costs. BellSouth Br. at 15; Qwest Br. at 16-17.

The Act's wholesale pricing provision does not implicitly or explicitly endorse either a historical or forward-looking cost model. *See* Sprint Resp't Br. at 24. The wholesale price

---

[1] Separate opposition briefs were filed by a group of incumbent local exchange carriers ("ILECs") (*see* Brief for Respondents BellSouth, SBC, Verizon, and USTA) ("BellSouth Br.") and (*see* Brief for Respondent Qwest Communications International, Inc.) ("Qwest") ("Qwest Br."). Except where noted, this reply brief addresses the arguments raised in both briefs.

is based on the ILEC's retail tariff—which state commissions could determine based on a forward-looking cost methodology or using the ILEC's historical costs. *Id.* The wholesale pricing provision is thus neutral on the issue. Nor does Section 252(d)(1)'s reference to a "reasonable profit" support any claim that the Act compels the use of historical costs. *Id.* at 19-20. As the Eighth Circuit succinctly stated, "[a] 'profit' can be made whether a historical cost or a forward-looking cost methodology is used." *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 752 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 13a).

The ILECs also contend that the Act's provision for pricing the transport and termination of traffic, Section 252(d)(2), further demonstrates that the Act requires historical costs. BellSouth Br. at 15. That provision, like the wholesale pricing provision, does not endorse a particular cost methodology, and the FCC concluded that the pricing of transport and termination under Section 252(d)(2) "should be based on the same cost-based standard" as the pricing provisions for network elements and interconnection in Section 252(d)(1). *Implementation of the Local Competition Provisions in the Telecomms. Act of 1996*, 11 F.C.C.R. 15,499, 16,023-24 (¶¶ 1054-1056) (1996) ("*Local Competition Order*"). This argument, therefore, circles back to the same path and again demonstrates that the Act's UNE pricing provision is ambiguous.

Qwest argues that if Congress intended for network element prices to be based on the cost of the most efficient network, "it could have, and would have, used language to that effect." Qwest Br. at 16. This analysis misses the mark. Congressional silence on the precise cost methodology to be used empowers the expert agency to make that determination. As this Court held, "Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999) ("*IUB I*"). If Congress intended to prohibit the FCC from using particular methodologies to implement the Act's pricing requirements, it would have legislated with more precision. Instead, Congress used the ambiguous terms "cost" and "just and reasonable." This Court has long held that a statutory requirement of "just and reasonable" rates allows an agency to select either a forward-looking or a historical cost methodology. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). *See also IUB II*, 219 F.3d at 751-52 (FCC Pet. App. 11a) (holding that "cost" is an ambiguous term); *Capital Network Sys., Inc. v. FCC*, 28 F.3d 201, 204 (D.C. Cir. 1994) (a statutory requirement of "just and reasonable" rates has long been understood to be ambiguous and to afford "substantial deference" to the implementing agency); Sprint Pet'r Br. at 13-20.

The ILECs also argue that the language in Section 252(d)(1) requiring UNE rates to be "based on the cost . . . of providing the . . . network element" necessarily refers to an ILEC's existing network. Thus, they contend, the reference to "cost" must mean the ILEC's historical costs to build its network. BellSouth Br. at 14-15; Qwest Br. at 15. This misconstrues the statutory language. By focusing on the "cost of . . . providing" the network element, the statutory language directs the inquiry to the economic costs resulting from the new entrant's use of the network element today and not the original price paid by the ILEC when the network was first built. Rather than base the price of network elements on obsolete or inefficient equipment that no one would purchase, the FCC's most efficient network rule reasonably measures the "cost of . . . providing" the UNE based on what the ILEC or any other carrier would pay in the marketplace today to provide the same functionalities. When properly read in full context, therefore, the statutory language not only allows for, but supports, use of a forward-looking methodology based on the least cost, most efficient technology available.

The ILECs attempt to demonstrate that the Act requires a historical cost methodology through a hypothetical example involving shipbuilding. They posit that if Congress required Newport News Shipbuilding ("NNS") to build a carrier, and Congress promised to pay the cost of providing the carrier, the Defense Department could not refuse to pay the costs NNS necessarily incurs and instead pay what it hypothesizes would be the costs if the whole shipyard were rebuilt from scratch. BellSouth Br. at 16. This analogy is flawed and only underscores the entrenched monopoly viewpoint of the ILECs. The Act does not require the ILECs to construct whole new networks. It only requires that they share existing elements of those networks based on rates that replicate a competitive marketplace. TELRIC properly measures those rates based on what it would cost an ILEC today to provide the UNE functions using the least cost, most efficient technology. Any actor facing competition would be required to price its offerings based on the same considerations, and not simply based on whatever costs it would like to pass on to its customers. While it may be difficult for the ILECs to adjust to this competitive approach, Congress certainly intended to create such an environment under the Act.

Finally, the ILECs rely on selected portions of the legislative history as support for the use of historical costs. Qwest Br. at 16; BellSouth Br. at 16 n.13. The cited legislative history makes no reference to any particular measure of cost. Indeed, the very same Senate Report cited by the ILECs states that "the State may not use or require a rate of return or other rate based proceeding to determine the cost of an unbundled element." S. Rep. No. 104-23, at 21 (1995). This language was ultimately incorporated into Section 252(d)(1)(A)(i), which expressly precludes any reference "to rate-of-return or other rate-based proceeding . . ." in establishing UNE prices. Because these kinds of proceedings typically use an ILEC's historical costs, one

must infer that Congress did not intend for UNE prices to be based on historical costs.

B. The FCC's Selection Of A Cost Methodology Based On The Most Efficient Replacement Technology Was Reasonable And Rule 505(b)(1) Should Be Reinstated.

1. Rule 505(b)(1) Simulates The Real World Costs To A New Entrant In A Competitive Environment.

The ILECs contend that Rule 505(b)(1) will not measure cost accurately because a new entrant would never be able to acquire a least cost, most efficient network "in the real world." They argue that telephone companies do not replace all of their equipment instantaneously, but instead use "anticipatory retardation" to replace equipment over time. They also contend that their ability to implement new, efficient technologies is constrained by "path dependency," which limits their choices because of the need to ensure compatibility with existing brands of equipment.[2] BellSouth Br. at 26-29; Qwest Br. at 31-33.

The ILECs' claims are based on the faulty premise that new entrants must bear the cost of the ILECs' prior strategic choices. The FCC elected to measure the cost of providing UNEs by examining what a new entrant would pay in the marketplace today to replace the functions at issue with efficient substitutes that can be used consistently with the location of the ILEC's existing wire centers. Even if it can be assumed that an ILEC chose not to deploy the most efficient

---

[2] Given the fact that ILECs account for an overwhelming share of the demand for new telephone equipment, it can be reasonably assumed that equipment vendors already consider "path dependency" concerns when designing their new products in order to maximize demand. The ILECs' "path dependency" concerns, therefore, are likely more theoretical than real.

equipment available because of "path dependency," in a competitive market the ILEC still would be forced to price its services against a competitor using such equipment. The ILEC's UNE prices would thus mirror its pricing behavior in the retail market. The FCC's choice of a methodology that incorporates these principles is certainly "within the bounds of the reasonable." *IUB I*, 525 U.S. at 395; *Chevron U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 865 (1984).

The ILECs further claim that the FCC's cost methodology assumes a market for network elements when none exists. BellSouth Br. at 19-20. Because no market exists, they contend, it is a theoretical exercise to try to calculate a forward-looking rate for UNEs. *Id.* This argument wrongly presumes that other cost methodologies—such as ones based on historical costs—are less theoretical than a forward-looking cost methodology. As shown in Sprint's earlier briefs, regulators have increasingly found forward-looking cost methodologies to be more reliable and practical than historical cost models. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 9.2 (1st ed. 1992) ("In practice, rate of return regulation usually culminates in poor regulation of cost, with prices allowed to float upward."); Sprint Resp't Br. at 23. The FCC also made a reasoned determination that TELRIC could be implemented based on the proven experience of the state commissions. *Local Competition Order*, 11 F.C.C.R. at 15,817-18, 15,847 (¶¶ 631, 681) (FCC Pet. App. 56a-58a, 67a-68a). That determination has been confirmed by the successful use of TELRIC—including Rule 505(b)(1)'s "most efficient replacement cost" component—by state commissions around the country.

The ILECs similarly contend that "no rational new entrant would enter" the market with a most efficient network on the terms posited by the FCC. BellSouth Br. at 28. They assert that a rational new entrant would price UNEs at a level above the most efficient replacement cost—demanding a higher rate

of return by charging prices well above TELRIC during the time it had a competitive advantage. *Id.* at 29; Qwest Br. at 33. They believe that the ability to gain a price advantage is the key incentive to use a new technology and that the FCC erred in assuming that an "instantaneous" price reduction would occur. Qwest Br. at 33.[3]

The FCC was not attempting to "simulate a theoretically perfect market through regulation," as the ILECs wrongly suggest. *Id.* at 21. Rather, the FCC selected a methodology that it determined would best replicate competitive market conditions. At the same time, the FCC sought to ensure that the rates eventually produced by that methodology would encourage new entrants to build competing facilities without stifling competition from the outset. *Local Competition Order*, 11 F.C.C.R. at 15,848-49 (¶ 685) (FCC Pet. App. 70a-71a). The agency concluded that TELRIC "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." *Id.* at 15,817 (¶ 630) (FCC Pet. App. 55a). Rule 505(b)(1)'s network configuration requirement is a reasonable and necessary component of that methodology. In contrast, the FCC determined that the use of historical costs would force competitors to pay for the existing inefficiency

---

[3] The ILECs argue that this "problem" is not ameliorated by the fact that most interconnection agreements are for three year terms. They contend that technologies and prices are not actually "locked in" for a three year period because the "pick and choose" rule permits CLECs to adopt different prices at any time, and interconnection agreements expire at different times. Qwest Br. at 36; BellSouth Br. at 33 n.25. These concerns are overstated and the ILECs conveniently ignore the fact that most states have conducted generic or consolidated proceedings involving all interested parties to establish industry-wide UNE prices for multi-year periods. *See, e.g., U S W. Communications, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1009-10 (D. Ariz. 1999); *Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc.*, No. 97-D-CA-132, 1998 U.S. Dist. LEXIS 15,637, at *8, *33-*34 (W.D. Tex. Aug. 31, 1998).

of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry . . . contemplated by the 1996 Act." *Id.* at 15,857-58 (¶ 705) (FCC Pet. App. 87a). The agency thus concluded that use of the ILECs' preferred methodology, not TELRIC, would discourage any "rational new entrant" from entering the market. That determination was well-supported and should be affirmed.

2. Rule 505(b)(1) Encourages Facilities-Based Competition.

Qwest contends that Rule 505(b)(1) discourages facilities-based investment by CLECs and thus detracts from Congress' goal of a deregulated local market. Qwest Br. at 23-24. In the "real world," Qwest argues, there is no such thing as a "most efficient, least cost provider." By establishing UNE rates based on this hypothetical provider, Rule 505(b)(1) will "always" make it more attractive for new entrants to lease UNEs rather than to build their own competitive facilities or to lease the same functionalities from a third party. *Id.* at 23-26.

Qwest conveniently ignores the fact that Rule 505(b)(1) incorporates an ILEC's existing wire centers and does not presume the most efficient, least cost provider in the truest sense. The FCC reasonably concluded that including this component as part of the TELRIC cost methodology would provide incentives to new entrants to construct their own facilities, using a more efficient network architecture. *Local Competition Order*, 11 F.C.C.R. at 15,848-49 (¶ 685) (FCC Pet. App. 70a-71a); Sprint Pet'r Br. at 19. Moreover, new entrants have incentives to offer service through their own facilities in order to avoid potential discrimination from the ILEC, *see Local Competition Order*, 11 F.C.C.R. at 15,656 (¶ 307), and to offer innovative services. In order to maintain market share, ILECs will also have incentives to invest in new facilities to compete with innovative services offered by CLECs. By stimulating competition, therefore, the FCC's

"most efficient network" rule promotes innovation and does not discourage new investments by ILECs, as Qwest wrongly argues. Qwest Br. at 27.

Qwest's argument also mistakenly assumes that a CLEC offering local service through UNEs will incur lower costs than a CLEC offering those same services through its own facilities in all cases and at all times. *Id.* at 23-25. There is nothing in the record to support that contention. Nor is there any basis to conclude that a new entrant serving customers through its own facilities would be at a disadvantage with other new entrants serving customers through leased UNEs. Were this the case, there would be a greater percentage of new entrants servicing local customers through leased network elements. Recent FCC data, however, indicates that no single method of competitive entry predominates. Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001).

3. The FCC's Cost Methodology Fairly Compensates ILECs For The Costs Of Providing UNEs.

The ILECs next contend that, by adopting Rule 505(b)(1), the FCC has "knowingly" deprived them of the ability to recover their costs. In particular, they argue that the FCC's treatment of rates of return and depreciation in TELRIC is arbitrary and capricious because it was based on the erroneous conclusion that ILECs "did not yet face significant facilities-based competition in the real world." BellSouth Br. at 30-31. The ILECs claim that the FCC "whipsawed" them by assuming that facilities would be instantaneously replaced while ignoring "the astronomical rates of return and depreciation expenses that would prevail in such a world." *Id.* at 31.

The ILECs' claims are overblown, if not disingenuous. In adopting TELRIC, the FCC used currently authorized rates of

return as a starting point and specifically instructed the state commissions to account for the effects of competition on ILECs in setting the depreciation rates and cost of capital. *Local Competition Order*, 11 F.C.C.R. at 15,856 (¶ 702) (FCC Pet. App. 83a-84a). Under this approach, "[s]tates may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted," due to emerging competition and other factors. *Id.* The FCC thus considered "real world" market conditions and gave the state commissions effective means to adjust for them in establishing UNE prices. Moreover, in the "real world" five years after the Act's passage, the ILECs still maintain over 92% of the local telecommunications market. Sprint Resp't Br. at 34. The ILECs cannot credibly claim that the FCC erred by failing to assume that they faced "significant facilities-based competition."

The ILECs further contend that it was arbitrary and capricious for the FCC to incorporate their existing wire center locations into Rule 505(b)(1) without including other aspects of their existing networks, such as telephone poles. BellSouth Br. at 23; Qwest Br. at 28. In fact, the FCC could have adopted a least cost, most efficient methodology that did not make *any* allowances for the inefficiencies of the incumbents' networks. After fully analyzing several alternatives, however, the FCC determined that incorporating existing wire centers into the cost methodology would provide proper incentives for CLECs to invest in their own facilities without overloading UNE prices with the inefficiencies of an ILEC's network. *Local Competition Order*, 11 F.C.C.R. at 15,848-49 (¶¶ 683-685) (FCC Pet. App. 69a-71a). The agency concluded that this approach was the best way to promote competition and to encourage innovation. That determination was not irrational and should be upheld.

Finally, Qwest alone acknowledges that forward-looking methodologies are permissible, but argues that TELRIC is flawed because it does not base costs on the ILEC's

"existing" network. Qwest Br. at 38-41. This approach, as the FCC correctly found, would be essentially an embedded cost methodology and would require CLECs to pay for the existing inefficiencies and obsolescence of the ILEC's network. *Local Competition Order*, 11 F.C.C.R. at 15,848 (¶ 684) (FCC Pet. App. 70a). The FCC also rejected the efficient component pricing rule ("ECPR") advocated by Qwest after finding that ECPR would inflate network element costs by providing purported "lost profits" to the ILECs. *Id.* at 15,859-60 (¶¶ 708-710) (FCC Pet. App. 89a-90a). Qwest now suggests that using price caps to determine network element prices would be appropriate. Qwest Br. at 40-41. Price caps are not cost-based. The FCC applied a price cap methodology to calculate access rates in the 1990s, in an attempt to introduce more efficiency incentives in the pricing of access. However, price cap regulation does not eliminate the ILECs' incentives to include inappropriate investments on their books, was largely abandoned by the FCC last year, and, in all events, would not comply with the Act's mandate that UNE prices be cost-based.

C. Rule 505(b)(1) Does Not Raise "Serious Constitutional Questions" Of A Takings Violation.

The ILECs use their challenge to Rule 505(b)(1) to reargue that denying them historical costs would raise "serious constitutional questions" under the Takings Clause. BellSouth Br. at 36. They contend that a forward-looking methodology based on the most efficient replacement cost forces them to "operate at a loss" and that a constitutional problem can only be avoided by adopting a pricing methodology that authorizes recovery of all historical costs. *Id.* at 36-38.

The FCC's adoption of Rule 505(b)(1) does not raise a serious constitutional question, for the reasons shown in Sprint's Brief in Support of the FCC Respondents. Sprint Resp't Br. at 28-43. Most notably, the ILECs have not shown—and cannot show—that the "total effect" of TELRIC

rates is so unjust as to be confiscatory. *Id.* at 34-39. Nor can the ILECs avoid the "total effect" test by claiming that state commissions are unable to determine UNE prices because there is no "market" for network elements. BellSouth Br. at 38-39. State commissions have been able to determine the value of the underlying components, labor, and material that make up the network elements, which provides an adequate basis for establishing the rates.

The ILECs also wrongly claim that they were promised "full-cost recovery at a utility rate of return" and that the "breaking" of this promise raises serious takings questions. *Id.* at 40. Yet, this Court has repeatedly held that reasonable investors are not entitled to expect an existing ratemaking scheme to be permanent or to claim entitlement to particular regulatory treatment. *E.g.*, *Tennessee Elec. Power Co. v. Tennessee Valley Auth.*, 306 U.S. 118, 141 (1939); *see also American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 397, 416 (1967). *Cf. New York Cent. R.R. v. White*, 243 U.S. 188, 198 (1917) ("No person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit."). The ILECs have no greater entitlement here. The FCC was authorized to determine the appropriate cost methodology to implement the Act's new regulatory regime. The FCC did not "break" any regulatory promise to the ILECs in carrying out its new mandate from Congress.

II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS DOES NOT VIOLATE SECTION 251(c)(3) OF THE ACT.

A. Section 251(c)(3) Is Ambiguous.

The ILECs argue that the "plain language" of Section 251(c)(3) forecloses CLECs from leasing UNEs "in combination" unless the network elements are already combined in the ILEC's network. *See* BellSouth Br. at 41-49. They

focus solely on the portion of the statute that reads "'in a manner that allows requesting carriers to combine such elements,'" arguing that the "plain assumption" to be drawn from this language is that CLECs themselves must combine the UNEs. *Id.* at 48 (citation omitted). Accordingly, the ILECs contend that Rule 315(c)-(f), which allows CLECs to request UNE combinations where technically feasible, violates the Act.

This Court previously held that the language of Section 251(c)(3) is ambiguous. In reinstating Rule 315(b) as a reasonable interpretation of the statute, this Court ruled that although UNEs may be requested in "discrete pieces," the statutory language "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *IUB I*, 525 U.S. at 394 (emphasis in original). The ILECs attempt to distinguish this Court's interpretation of Section 251(c)(3) by arguing that a rule prohibiting ILECs from separating already combined UNEs "is very different" from a rule requiring ILECs to combine UNEs upon request. BellSouth Br. at 44. In practical effect, however, Rule 315(b) and Rule 315(c)-(f) are opposite sides of the same coin. Both rules are designed to ensure that CLECs are able to obtain UNEs in a manner that permits them to provide competitive local services, as Congress intended. *Local Competition Order*, 11 F.C.C.R. at 15,648 (¶ 296) (FCC Pet. App. 47a-48a). Rule 315(b) precludes ILECs from separating already combined UNEs because, as both the FCC and this Court recognized, doing so would unnecessarily increase a CLEC's costs in leasing the elements. This Court concluded that the agency was right to prohibit such an anti-competitive practice. *IUB I*, 525 U.S. at 394-95. Rule 315(c)-(f) accomplishes the same objectives, by requiring ILECs to combine UNEs for CLECs when it is technically feasible to do so. *Local Competition Order*, 11 F.C.C.R. at 15,648 (¶ 296) (FCC Pet. App. 47a-48a). The FCC determined that this approach was necessary "given the

practical difficulties of requiring requesting carriers to combine elements that are part of the incumbent LEC's network." *Id.* at 15,647 (¶ 294) (FCC Pet. App. 46a). The agency correctly found that it would be more efficient and reliable for the ILECs who own and control the networks to do the combining. The CLECs, in turn, must pay the ILECs for this service. Absent such a rule, the FCC found, "requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets." *Id.* at 15,647 (¶ 293) (FCC Pet. App. 45a).

Ironically, the ILECs have vigorously objected to providing physical access to their networks in other contexts. *Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. 3696, 3910 (¶ 482) (1999). Under the UNE combinations rule, the ILECs keep control of their networks and are to be fairly compensated for providing combining services to CLECs. The only reason an ILEC would object to the rule under these circumstances is to impede access to UNEs and to increase new entrants' costs. As this Court found in *IUB I*, the FCC was right to prohibit such anti-competitive practices.

The ILECs also attempt to argue that Rule 315(c)-(f) is more akin to the "superior quality" rules that were vacated by the Eighth Circuit than to Rule 315(b). BellSouth Br. at 47. This analogy is flawed. The "superior quality" rules required ILECs to provide interconnection and unbundled access at levels of quality superior to those at which they provided such services to themselves. The Eighth Circuit found that these rules violated the plain language of Section 251(c)(2)(C), which only requires ILECs to provide interconnection that is at least equal in quality and thus "establishes a floor below which the quality of interconnection may not go." *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 812 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). In contrast, Rule 315(c)-(f) is designed

to deter anti-competitive conduct and to ensure meaningful access to an ILEC's existing network facilities. The rule only requires that an ILEC combine UNEs when it is technically feasible to do so. Under this standard, the ILEC is equally capable of combining the UNEs for its own use as it is for a requesting CLEC. Nothing in the rule requires the ILEC to provide any service to a CLEC that is "superior" to what the ILEC can currently provide to itself.

B. The UNE Combinations Rule Is Reasonable And Necessary To Ensure Meaningful UNE Access.

The ILECs next argue that Rule 315(c)-(f) is unreasonable because there is nothing "discriminatory" about requiring CLECs to combine UNEs. BellSouth Br. at 45. As shown, the FCC found to the contrary. Based on the record, the FCC logically concluded that CLECs were not on equal footing with ILECs in obtaining access to the ILECs' networks and that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements." *Local Competition Order*, 11 F.C.C.R. at 15,647 (¶ 293) (FCC Pet. App. 45a). As a consequence, the agency determined that CLECs would be unable to offer local services using UNEs on the same level as the ILEC without the combinations rule.

Because Section 251(c)(3) is ambiguous, the FCC was authorized to interpret the statute in light of these policy concerns. *IUB I*, 525 U.S. at 394-95. Experience has proven that these concerns were well-founded. Some ILECs still refuse to provide access to network elements so that CLECs can combine them, effectively defeating the statutory intent. *Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. at 3910 (¶ 482). Attempts by CLECs to obtain access to networks to combine UNEs have also proven to be unworkable and easily

obstructed by ILECs. The CLECs' experiences in Colorado are illustrative. The Colorado state commission rejected an ILEC proposal that would "allow" CLECs to combine network elements. The Colorado commission concluded that the proposal "does not provide a reasonable opportunity for CLECs to combine UNEs and thus creates an unnecessary barrier to the development of competition in Colorado." *Investigation and Suspension of Tariff Sheets Filed by U S W. Communications, Inc.*, Docket No. 96S-331T, Decision No. C98-1047 at 13-15 (Colo. Pub. Utils. Comm'n Oct. 1, 1998). One witness explained "that with [an ILEC's] modern telephone network, loops or trunks are 'moved' electronically through software, and to propose anything different would be to move backwards through time and technology." *Id.* at 12. Based on these and other problems, the Colorado commission found that the ILEC's proposal was "discriminatory," "inefficient," and would cause "unnecessary service disruption to customers." *Id.* at 13-16.

The ILECs also argue that the combinations rule is infected with the same improper analysis underlying the FCC's original Rule 319, which identified the UNEs subject to the access requirements of Section 251(c)(3). In *IUB I*, this Court held that the FCC "did not adequately consider the 'necessary and impair' standards" of Section 251(d)(2) in determining which UNEs must be made available by ILECs. 525 U.S. at 387-88. The Court found that the "necessary and impair" standard meant something more than simply showing that a CLEC would incur higher costs without access to a UNE and that such access was "technically feasible." *Id.* at 390-92.

A determination of which UNEs must be unbundled is different from a determination that ILECs should be required to combine UNEs upon request. The statutory standard prescribed by Congress for the former examines whether particular UNEs are necessary for new entrants to compete. This involves, among other things, consideration of available

substitutes for the same functionalities in the marketplace. The statutory duty prescribed by Congress for the latter requires that CLECs be afforded meaningful *access* to the requisite UNEs, once identified. The FCC found that Rule 315(c)-(f) was necessary to ensure such access. Without it, the pro-competitive goals underlying both Sections 251(c)(3) and 251(d)(2) are defeated.[4]

The ILECs cite to the FCC's reference to "technical feasibility" in Paragraph 296 of the *Local Competition Order* as evidence that the agency's analysis of Rule 315(c)-(f) was tainted by the same analysis underlying Rule 319. A fair reading of the agency's discussion proves otherwise. The FCC was reasonably concerned that "network reliability and security factors" may make it technically infeasible for an ILEC to combine UNEs in certain circumstances, even when the individual elements must be made available on an unbundled basis. The agency's provision for this practical possibility in no way undermines the general conclusion that the combinations rule is necessary both to afford CLECs meaningful access to UNEs and to prevent discriminatory practices by ILECs.

The ILECs also wrongly claim that the FCC "acknowledged" that its "technical feasibility standard for additional combinations 'is consistent with the [FCC's] *method* . . . adopted to identify unbundled network elements.'" BellSouth Br. at 46 (citing Paragraph 295 of the *Local Competition*

---

[4] The ILECs attempt to equate the FCC's concerns over an ILEC's ability to impose wasteful costs on CLECs by forcing them to combine UNEs with the FCC's discredited view that any cost savings to a CLEC satisfied the "necessary and impair" standard under Rule 319. BellSouth Br. at 49. This argument is equally strained. The combinations rule is designed to ensure that CLECs have meaningful access to UNEs *and* to prevent ILECs from imposing "wasteful" costs. Either objective would support the rule and this Court already found that protecting CLECs from "wasteful" costs was a reasonable basis for Rule 315(b). *IUB I*, 525 U.S. at 395.

Order) (emphasis added). This again takes the agency's discussion out of context. In the quoted paragraph, the FCC explained that the combinations rule is consistent with the agency's general definitional approach to determining what constitutes a "network element," which may include several parts. *Local Competition Order*, 11 F.C.C.R. at 15,648 (¶ 295) (FCC Pet. App. 46-47a). As stated by the agency:

> Under our method, incumbents must provide, as a single, combined element, facilities that could comprise more than one element. . . . [F]or example, . . . if the states require incumbent LECs to provision subloop elements, incumbent LECs must still provision a local loop as a single, combined element when so requested, because we identify local loops as a single element in this proceeding.

Id. This Court upheld the FCC's "method" of determining which equipment and features of an ILEC's system constitute "network elements" under Section 251(d)(2). The Court found that the agency's approach was "eminently reasonable," particularly in view of "the breadth of [the Act's] definition" of a "network element." *IUB I*, 525 U.S. at 387. The same deference should be afforded to the FCC's determinations underlying the combinations rule.

Finally, the ILECs' reliance on *GTE Service Corp. v. FCC*, 205 F.3d 416, 424 (D.C. Cir. 2000) is misplaced. In that case, the D.C. Circuit evaluated whether particular aspects of the FCC's collocation rules complied with the "necessary" standard prescribed in Section 251(c)(6). The D.C. Circuit upheld many of the FCC's collocation rules as reasonable under *Chevron*. For example, the court upheld a rule that prohibited ILECs from charging new entrants the entire cost of site preparation and required the ILECs to allocate the costs based on the space actually used by the particular CLEC. The court found that this rule was "a reasonable way to ensure that LECs do not impose prohibitive requirements on new competitors and thus kill competition before it ever

gets started." *Id.* at 427. The D.C. Circuit's reasoning supports a similar finding that Rule 315(c)-(f) is "a reasonable way" to ensure that new entrants can compete in the local telecommunications market by having meaningful access to network elements.

C. Review Of The Combinations Rule Was Not Waived.

The ILECs contend that this Court should not address the validity of Rule 315(c)-(f) because the challenge was not preserved in *IUB I*. This argument ignores subsequent history. Although this Court did not review Rule 315(c)-(f) in its decision, the Eighth Circuit on remand ordered the parties to address "whether or not, in light of the Supreme Court's decision, this court should take any further action with respect to . . . § 51.315(c)-(f) . . . ." *Iowa Utils. Bd. v. FCC*, Nos. 96-3321 *et al.*, Order at 2-3 (8th Cir. June 10, 1999). The Eighth Circuit then reviewed its prior determination and upheld its vacation of Rule 315(c)-(f) *on the merits*. *IUB II*, 219 F.3d at 758-59 (FCC Pet. App. 26a-29a).

This Court granted *certiorari* on "[w]hether 47 U.S.C. [§] 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task." *Verizon Communications, Inc. v. FCC*, 121 S. Ct. 877 (2001). The question presented goes to the merits of the combinations rule and is based on the Eighth Circuit's most recent decision. *Cf.* Sup. Ct. R. 19.4 ("If the Court orders that the case be briefed or set for argument, the parties shall be notified and permitted to file briefs."). It borders on the frivolous to argue that the issue was waived under these circumstances.

The ILECs cite to *Communist Party of the United States v. Subversive Activities Control Board*, 367 U.S. 1 (1961) in

support of their waiver argument. *Communist Party* involved a challenge to an agency order on a procedural ground that was not raised in the first appeal. The Court found that it would be improper to allow a party to gain an advantage as a result of procedural gamesmanship. *Id.* at 30-31. The question presented here, in contrast, involves a substantive issue that affects the entire telecommunications industry, was reconsidered on the merits by the Eighth Circuit on remand, and has been accepted for review by this Court. Moreover, review of the question by this Court will resolve a conflict between the courts of appeals over the lawfulness of the combinations rule under Section 251(c)(3). *See* WorldCom, Inc.'s Pet. at 23-27. No party will be disadvantaged by review of the issue under these circumstances.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court reinstate 47 C.F.R. § 51.505(b)(1) and 47 C.F.R. § 51.315(c)-(f).

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent
Sprint Corporation

JUL 23 2001

Supreme Court, U.S.
FILED
JUL 23 2001
CLERK

Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR PETITIONERS UNITED STATES AND THE FEDERAL COMMUNICATIONS COMMISSION

THEODORE B. OLSON
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

TABLE OF CONTENTS

		Page
I.	The FCC's choice of TELRIC to determine the "cost" of network elements is entitled to *Chevron* deference	1
	A. The FCC's adoption of a methodology based on the forward-looking cost of providing a given element, using the most efficient available technology, is consistent with the text and purpose of the 1996 Act	1
	B. The FCC's choice of a methodology based on the forward-looking cost of providing a given element, using the most efficient available technology, is reasonable	3
II.	The FCC's combinations rules are entitled to *Chevron* deference	15
	A. The challenge to the Eighth Circuit's invalidation of Rules 315(c)-(f) has not been waived	15
	B. Rules 315(c)-(f) are the product of an expert agency's reasonable construction of ambiguous statutory language	16

TABLE OF AUTHORITIES

Cases:

AT&T v. *FCC*, 200 F.3d 607 (D.C. Cir. 2000) 6, 10

AT&T v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999) 2, 15, 16, 18, 20

Cassell v. *FCC*, 154 F.3d 478 (D.C. Cir. 1998) 5

Chevron U.S.A. Inc. v. *NRDC, Inc.*, 467 U.S. 837 (1984) 3, 15, 17

City of Los Angeles v. *United States Dep't of Transp.*, 165 F.3d 972 (D.C. Cir. 1999), cert. denied, 528 U.S. 1074 (2000) 4

Cases—Continued: Page

Communist Party v. *Subversive Activities Control Bd.*, 367 U.S. 1 (1961) 16
Duquesne Light Co. v. *Barasch*, 488 U.S. 299 (1989) 13
Farmers Union Cent. Exch., Inc. v. *FERC*, 734 F.2d 1486 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984) 13
MCI Communications Corp. v. *AT&T*, 708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983) 14
Missouri ex rel. S.W. Bell Tel. Co. v. *Public Serv. Comm'n*, 262 U.S. 276 (1923) 7
Permian Basin Area Rate Cases, 390 U.S. 747 (1968) 3
United States v. *Cors*, 337 U.S. 325 (1949) 13

Constitution, statutes and regulations:

U.S. Const. Amend. V (Just Compensation Clause) 13
Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ..... 1, 2, 3, 13, 14
47 U.S.C. 153(29) (Supp. V 1999) 2
47 U.S.C. 160(d) (Supp. V 1999) 14
47 U.S.C. 251(c)(3) (Supp. V 1999) 16, 17, 18, 19-20
47 U.S.C. 252 (Supp. V 1999) 12
47 U.S.C. 252(b) (Supp. V 1999) 14
47 U.S.C. 252(d)(1) (Supp. V 1999) 1, 2
47 U.S.C. 252(d)(1)(A)(i) (Supp. V 1999) 14
47 U.S.C. 252(d)(1)(B) (Supp. V 1999) 3
47 U.S.C. 252(d)(3) (Supp. V 1999) 3
47 U.S.C. 252(e)(5) 14
47 C.F.R.:
Section 51.311(c) 20
Section 51.315(b) 17, 18
Section 51.315.(c)-(f) 15, 16, 17, 18, 19, 20
Section 51.319 20
Section 51.505(b)(1) 5, 20

Regulations—Continued: Page

Section 51.505(b)(2) 10, 12
Section 51.505(b)(3) 10, 12
Section 51.505(c) 10

Miscellaneous:

William J. Baumol & Thomas W. Merrill, *Does the Constitution Require that We Kill the Competitive Goose? Pricing Local Services to Rivals*, 73 N.Y.U.L. Rev. 1122 (1998) 8
James C. Bonbright et al., *Principles of Public Utility Rates* (1988) 7
Deployment of Wireline Servs. Offering Advanced Telecomms. Capability, 14 F.C.C.R. 20,912 (1999), petition for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, Nos. 00-1012 et al. (D.C. Cir. Jan. 18, 2000) 10
Herbert Hovenkamp, *The Takings Clause & Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999) (book review) 9
Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, 15 F.C.C.R. 3696 (1999), petition for review pending *sub nom.*, *United States Telecom Ass'n* v. *FCC*, Nos. 00-1015 et al. (D.C. Cir. Jan. 19, 2000) 15, 18, 19
1 Alfred E. Kahn, *The Economics of Regulation: Principles & Institutions* (1988) 7
Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exch. Carriers, 5 F.C.C.R. 7507 (1990), aff'd *sub nom. Illinois Bell Tel. Co.* v. *FCC*, 988 F.2d 1254 (D.C. Cir. 1993) 12

In the Supreme Court of the United States

Nos. 00-511, 00-555, 00-587, 00-590 AND 00-602

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR PETITIONERS UNITED STATES AND THE FEDERAL COMMUNICATIONS COMMISSION

I. THE FCC'S CHOICE OF TELRIC TO DETERMINE THE "COST" OF NETWORK ELEMENTS IS ENTITLED TO *CHEVRON* DEFERENCE

A. The FCC's adoption of a methodology based on the forward-looking cost of providing a given element, using the most efficient available technology, is consistent with the text and purpose of the 1996 Act

The "general terms" that Congress employed in 47 U.S.C. 252(d)(1) to articulate the pricing standard for network elements—"just and reasonable" rates "based on * * * cost" —"give ratesetting commissions broad methodological lee-

way" and "say little about the 'method employed' to determine a particular rate." *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 423 (1999) (Breyer, J., concurring in part and dissenting in part). In view of the flexibility inherent in the statutory language, the competitive purposes of the 1996 Act, and the contemporaneous use of similar forward-looking methodologies by other regulators, the Eighth Circuit erred in holding that the "plain language" of Section 252(d)(1) foreclosed the choice of TELRIC to set network element rates. See U.S. Pet. Br. 21-31; U.S. Resp. Br. 16-26.

The incumbent local exchange carriers contend that TELRIC is inconsistent with 47 U.S.C. 252(d)(1), which states that rates for network elements be "based on the cost * * * of providing the * * * network element." They argue that the statutory text, if it permits the adoption of *any* forward-looking methodology at all, requires the adoption of a methodology based on what they characterize as "actual" forward-looking costs. See Br. for Respondents BellSouth *et al.* (BellSouth Resp. Br.) 14-15. They do not define that concept, but they appear to suggest that the Act requires that network element prices be tied to the prices of their existing facilities. Nothing in the statutory text, however, requires the FCC to adopt a ratemaking methodology that is constrained in that fashion. The Act requires compensation for the "cost * * * of *providing*," 47 U.S.C. 252(d)(1) (emphasis added), the "features, functions and capabilities" that constitute network elements, 47 U.S.C. 153(29). The text permits the FCC to choose a methodology, such as TELRIC, that is based on the forward-looking costs of providing those "features, functions, and capabilities" using the most efficient technology available on the market. Those are the costs that carriers in competitive markets would *actually* consider in making decisions concerning entry, pricing, and investment.

The incumbents also contend that the Eighth Circuit's construction of the network element pricing standard is mandated by other provisions of the 1996 Act—the same provisions that the incumbents elsewhere invoke as mandating a contrary construction of the network element pricing standard based on historical costs. Compare Verizon Pet. Br. 19-23, with BellSouth Resp. Br. 14-16. We have explained why those provisions evince no intent by Congress to restrict the FCC to any particular pricing methodology. See U.S. Resp. Br. 22-26.[1]

B. The FCC's choice of a methodology based on the forward-looking cost of providing a given element, using the most efficient available technology, is reasonable

The incumbents principally argue not that TELRIC is contrary to the text of the 1996 Act and thus fails the first step of *Chevron U.S.A. Inc.* v. *NRDC*, 467 U.S. 837, 842-843 (1984), but that TELRIC is based on unreasonable economic assumptions and thus fails the second step of *Chevron*. "[N]either law nor economics," however, "has yet devised generally accepted standards for the evaluation of rate-making orders." *Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968). The fact that "some or many economists

---

[1] The incumbents contend, for example, that TELRIC is inconsistent with the reference to "a reasonable profit" in 47 U.S.C. 252(d)(1)(B) and with the rate standard in 47 U.S.C. 252(d)(3) for services purchased by new entrants for resale to consumers, which is tied to incumbents' retail rates. TELRIC incorporates the concept of "reasonable profit," however, and thus comports with Congress's provision that network element rates "may include a reasonable profit." See U.S. Resp. Br. 22-23. The purchase of services for resale and the lease of network elements are distinct entry vehicles, and the pricing standards for those entry vehicles are described in different terms in different statutory subsections. There is thus no reason to conclude that Congress meant the two standards to be identically tied to incumbents' existing circumstances. See *id.* at 24-26.

would disapprove of the [agency's] approach does not answer the question presented" to a court on review of the agency's rate-making decisions, because courts "do not sit as a panel of referees on a professional economics journal, but as a panel of generalist judges obliged to defer to a reasonable judgment by an agency acting pursuant to congressionally delegated authority." *City of Los Angeles* v. *United States Dep't of Transp.*, 165 F.3d 972, 977 (D.C. Cir. 1999) (Silberman, J.), cert. denied, 528 U.S. 1074 (2000). Such deference is fully warranted here.

1. After careful review of an extensive record, which included economic commentary on all sides of the issue (see *Local Competition Order* (paras. 635-671), J.A. 340-375), the FCC adopted TELRIC, which the FCC viewed as providing the best approximation of an incumbent's forward-looking cost of providing network elements to itself and others, if the incumbent acted rationally in a competitive market. See *Local Competition Order* (paras. 672-679, 685), J.A. 375-380, 383-384. The FCC selected a long-run period for measuring costs in order to "ensure[] that rates recover not only the operating costs that vary in the short run, but also fixed investment costs that, while not variable in the short term, are necessary inputs directly attributable to providing the element." *Local Competition Order* (para. 692), J.A. 387-388.

The FCC recognized that an economically rational carrier can be expected, over the long run, to construct a network with "the most efficient network architecture, sizing, technology, and operating decisions that are operationally feasible and currently available to the industry." *Local Competition Order* (para. 683), J.A. 382-383. But the FCC did not fully incorporate that expectation into TELRIC. The FCC instead decided that TELRIC should take as given the "existing network design" so that "wire centers will be placed at the incumbent LEC's current wire center locations"—*i.e.*, switches will continue to be deployed at

existing locations, and loops and transport trunks will continue to terminate at those locations. See *Local Competition Order* (para. 685), J.A. 383-384; see also 47 C.F.R. 51.505(b)(1). The FCC concluded that such a hybrid of "existing" and "most efficient" design would serve multiple purposes: It would mitigate incumbents' concerns that TELRIC would not reflect the additional costs attributable to past decisions regarding the most fundamental aspects of their existing networks; it would encourage new entrants to design and build networks of their own, to the extent that they could thereby operate more efficiently than they could by leasing elements of incumbents' networks; and it would enable state public utility commissions to implement TELRIC more expeditiously based on existing models that typically incorporated a wire-center limitation. See *Local Competition Order* (para. 685), J.A. 383-384.[2]

The FCC might reasonably have omitted the "wire centers" limitation, or it might reasonably have drawn the line somewhere else within the structure of the network. Choosing among such options, however, is a classic exercise in administrative line-drawing, and courts do not generally upset an agency's choice in such matters unless the lines drawn "are patently unreasonable, having no relationship to the underlying regulatory problem." *Cassell* v. *FCC*, 154 F.3d 478, 485 (D.C. Cir. 1998). Here, the FCC drew an entirely reasonable line, balancing the conceptual benefits of a pure forward-looking approach against the practical

---

[2] The incumbents thus err in asserting (BellSouth Resp. Br. 18) that "the FCC has simply overlooked the fundamental fact that, in an industry with long-lived capital investment, a carrier is constrained by its existing network." The FCC explicitly took that "fundamental fact" into account in incorporating the "wire centers" limitation into TELRIC, as well as in providing for TELRIC rates to reflect depreciation and the cost of capital (see pp. 10-12, *infra*).

advantages (and administrative convenience) of taking into account the basic architecture of the existing network. The incumbents present no legally sufficient basis for compelling the FCC to draw a different line.

2. The incumbents argue that any reasonable forward-looking methodology would have to be tied to their "actual" forward-looking costs, as opposed to the forward-looking costs of a "hypothetical" carrier. See BellSouth Resp. Br. 11-12, 14. But they do not explain what they mean by "actual" forward-looking costs. By definition, forward-looking costs, in contrast to historical costs recorded in regulatory books of account, do not replicate actual past outlays. They are instead "costs that a carrier would incur in the future." *Local Competition Order* (para. 683), J.A. 382-383.[3] The costs measured by TELRIC are nonetheless those of the incumbent itself. Those costs are based, moreover, on actual prices of equipment that is commercially available today—equipment that carriers are already using to upgrade and expand their networks. See, *e.g.*, *AT&T* v. *FCC*, 220 F.3d 607, 617 (D.C. Cir. 2000) (state commission, in setting TELRIC price for switching element, looked to prices of switches recently purchased by incumbent).

The incumbents appear to be proposing a methodology based on the "actual" cost, in today's market, of duplicating "actual" existing networks in all physical particulars—or, stated differently, the "application of up-to-date prices to

[3] Any forward-looking cost methodology is necessarily predictive, and thus "hypothetical," to the extent that it must, for example, establish appropriate depreciation rates and costs of capital. See pp. 10-12, *infra*. But the fact that a rate methodology involves predictive judgments does not render it economically untenable. Many aspects of traditional historical cost ratemaking also require such judgments. See U.S. Pet. Br. 30-31; U.S. Resp. Br. 48; see also Public Serv. Comm'n of N.Y. Br. 10-11 (explaining that "ratemaking is essentially a prospective, forward-looking, exercise," whatever the particular methodology applied) (emphasis omitted).

out-of-date properties." James C. Bonbright et al., *Principles of Public Utility Rates* 294 (1988). Economists, including those upon whom the incumbents rely, uniformly agree that such a measurement is "economically meaningless." *Ibid*; accord 1 Alfred E. Kahn, *The Economics of Regulation: Principles & Institutions* 112 (1988); see also *Missouri ex rel. S.W. Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 312 (1923) (Brandeis, J., dissenting) (disparaging, as the *least* appropriate cost methodology, an inquiry into "what it would cost to reproduce the identical property"). The FCC considered, but rejected, such an approach as "essentially an embedded [*i.e.*, historical] cost methodology," which would produce "prices for interconnection and unbundled elements that reflect inefficient or obsolete network design and technology." *Local Competition Order* (para. 684), J.A. 383. Such prices would distort a competing carrier's analysis of whether, or how, to enter a local telecommunications market, by encouraging, for example, the carrier to construct inefficient, duplicative facilities. See *Local Competition Order* (paras. 620, 630, 679), J.A. 327-328, 333-334, 379-380.[4]

3. The incumbents assert that TELRIC assumes that a carrier would scrap its existing network and rebuild a new, more efficient one every time an advance in technology occurs. See, *e.g.*, BellSouth Resp. Br. 12, 26-27. TELRIC assumes no such thing.

[4] Another possible measure of "actual" forward-looking costs would take into account only incumbents' short-run incremental costs. Such a measure finds some support in the Eighth Circuit's decision. See U.S. Pet. App. 9a-10a ("In our view it is the cost to the ILEC of carrying the *extra burden* of the competitor's traffic that Congress entitled the ILEC to recover.") (emphasis added). But that approach would yield rates *lower* than TELRIC in the usual case in which no additional capital investment beyond that which has already been made is needed to provide network elements to a new entrant. It is thus unlikely that the incumbents would support such an alternative.

TELRIC instead rests on the rational economic assumption that, as new, more efficient equipment becomes available, the value of older, less efficient equipment will be affected. To use an example suggested by the incumbents (see BellSouth Resp. Br. 26), if new, more fuel-efficient aircraft were to become available, airlines would not necessarily respond by immediately replacing their older, less fuel-efficient aircraft, which could still have a significant useful life. The relevant point is that the market value of the older aircraft would depend *not* on what the owner originally paid for it, but on the cost of continuing to operate it relative to the cost of acquiring and operating the new equipment. Thus, if an airline were to offer to sell or lease its older aircraft, the price at which it could do so would be constrained by the cost of acquiring and operating the new aircraft. Airlines considering whether, or how, to enter the market would base their decision, in significant part, on that cost.[5] To serve its goals of promoting competition and efficiency in local telecommunication markets while providing fair compensation to incumbents, the FCC similarly required state commissions to use the long-run forward-looking costs of providing network elements using the most efficient technology currently available.[6]

---

[5] See, *e.g.*, William J. Baumol & Thomas W. Merrill, *Does the Constitution Require that We Kill the Competitive Goose: Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. Rev. 1122, 1147 (1998) (explaining that the "threat of potential competition" from new entrants with more efficient equipment will cause "even incumbents with outdated high-cost equipment * * * to adjust their prices to efficient costs"). Professors Baumol and Merrill observe that, although an incumbent may not immediately reduce its own prices all the way to forward-looking costs of the more efficient equipment, the incumbent will do so over the relative short term. Compare BellSouth Resp. Br. 16 (faulting the FCC for supposedly assuming that price adjustments would be rapid).

[6] The incumbents complain that the FCC, in adopting TELRIC, is "creat[ing] the *appearance* of competition," not "real competition," which the incumbents view as limited to facilities-based competition. BellSouth Resp. Br. 2. But it was Congress, not the FCC, that chose to foster competition in local telecommunications markets in a variety of ways, including by enabling new entrants to lease elements of incumbents' networks. Congress understood, for example, that new entrants could thereby develop the expertise, capital, and customer base that they might need in order to support extensive construction of new facilities. Moreover, contrary to the incumbents' suggestion, new entrants are, in fact, competing in local telecommunications markets by serving customers with their own facilities as well as facilities leased from incumbents. See U.S. Resp. Br. 44-46.

The question thus is not, as the incumbents suggest, whether it is sometimes prudent for a firm to make do with dated assets even after more efficient alternatives appear on the market. The question, instead, is whether those alternatives may reasonably be taken into account in determining the compensation to which a firm is entitled for the use of those assets. The answer is clearly yes. In the closely analogous circumstances of the government's condemnation of the assets of a private firm (*e.g.*, a printing plant), the owner could not demand compensation above fair market value for its obsolescent assets (*e.g.*, manual "hot type" equipment), even if the owner had acted reasonably in not replacing those assets as soon as more efficient alternatives (*e.g.*, computerized "cold type" equipment) appeared on the market. See generally Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801, 828-830 (1999). TELRIC entitles incumbents to a recovery that approximates fair market value. See U.S. Resp. Br. 35-36.[7]

---

[7] Similarly, TELRIC, contrary to the incumbents' contention (BellSouth Resp. Br. 7), does not assume that an efficient carrier would provide the switching element with large-capacity switches, rather than with a mix of smaller switches and so-called "add-on modules." See *AT&T* v. *FCC*, 220 F.3d at 616-618 (upholding FCC's decision that New York Public Service Commission had not misapplied TELRIC in failing to set switching rates based on discounted prices that ignored growth additions).

4. The incumbents contend that, because the forward-looking costs of some facilities will predictably decrease over their expected lives, TELRIC will preclude a carrier from ever recovering its full forward-looking costs. That argument is incorrect.

In calculating how a carrier may recover the forward-looking costs of particular network elements, TELRIC takes into account not only the direct forward-looking cost of constructing, maintaining, and operating an element, but also the appropriate rate of depreciation, which reflects how quickly a carrier must recover those costs in order to account for the prospects of wear and tear and technological obsolescence. See 47 C.F.R. 51.505(b)(3); *Local Competition Order* (paras. 702-703), J.A. 395-396. TELRIC also takes into account the forward-looking cost of capital and a reasonable allocation of forward-looking common costs. See 47 C.F.R. 51.505(b)(2) and (c).

Virtually all cost methodologies assume that, although a prudent firm would not necessarily replace a facility the moment a more efficient substitute appears on the market, the firm ordinarily would replace that facility at some point. Those methodologies consequently require regulators to determine the useful life of an asset and to provide an opportunity for cost recovery within that period. TELRIC is no different. It thus accommodates reasonable economic assumptions about future technological advances and the effects those advances will have on the value of current assets. Indeed, in the FCC rulemaking that produced

---

In addition, the incumbents' suggestion (BellSouth Resp. Br. 7-8) that TELRIC authorizes regulators to require incumbents to modify, "for free," loops to facilitate certain advanced services ignores express FCC directions to the contrary. See *Deployment of Wireline Servs. Offering Advanced Telecomms. Capability*, 14 F.C.C.R. 20,912, 20,954, 20,978-20,979 (1999) (paras. 87, 148), petition for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, No. 00-1012 (D.C. Cir. Jan. 18, 2000).

TELRIC, the incumbents acknowledged that an accurate calculation of economic depreciation and the cost of capital would obviate the problem that they allege here. See Declaration of Alfred E. Kahn & Timothy J. Tardiff 3-4 (Reply Comments of Bell Atl., Ex. 1), *Implementation of the Local Competition Provisions in the Telecomms. Act of 1996*, CC Docket No. 96-98 (FCC filed May 30, 1996).

In the local competition context, the FCC has not prescribed particular depreciation schedules for network elements. The FCC has instead left it to state public utility commissions to determine how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." *Local Competition Order* (para. 686), J.A. 384-385. Among their many options, state commissions could, where circumstances warrant, adopt accelerated depreciation schedules that provide faster recovery of incumbents' forward-looking costs at the beginning of the relevant period than at the end, or state commissions could choose some other method of ensuring adequate recovery of forward-looking costs. The incumbents provide no basis for questioning the ability of state commissions, in applying TELRIC to particular circumstances, to provide full recovery of incumbents' forward-looking costs.

The incumbents are also incorrect in asserting that TELRIC requires state commissions to retain the depreciation schedules and cost of capital determinations that were set under prior historical-cost ratemaking regimes. See BellSouth Resp. Br. 31-33. Although the FCC stated that existing determinations provide "a reasonable starting point for TELRIC calculations," *Local Competition Order* (para. 702), J.A. 395-396, the FCC was merely offering tentative guidance at a time when state commissions had to make large numbers of ratemaking determinations under the short

time frames established in Section 252. The statement does not alter the governing standard, set forth in the rules, that requires state commissions to determine the true economic depreciation rate and risk-adjusted cost of capital. 47 C.F.R. 51.505(b)(2) and (3). Indeed, the FCC specifically directed state commissions to depart from the previously established depreciation and cost of capital determinations when incumbents show that those determinations do not comply with that standard. *Local Competition Order* (para. 702), J.A. 395-396.[8]

5. The incumbents reassert their arguments that, in order to avoid Takings Clause concerns, the 1996 Act must be construed to foreclose TELRIC. See BellSouth Resp. Br. 36-41. The incumbents are incorrect for reasons previously explained. See U.S. Resp. Br. 26-41. The incumbents make no effort here to substantiate their claim (BellSouth Resp. Br. 36-37) that TELRIC, as applied by state commissions, is producing network element rates that are "noncompensatory" of incumbents' "actual" forward-looking costs (or their costs by any other measure).

The incumbents further contend that the FCC's use of TELRIC to produce rates similar to those that would exist in a competitive market violates constitutional principles and statutory goals where, as here, a competitive market does not yet exist. See BellSouth Resp. Br. 19-20, 38-41; Qwest Br. 18-20. Such arguments disregard that a central objective

[8] Moreover, an appropriate cost of capital determination takes into account not only existing competitive risks, as the FCC explicitly recognized (see *Local Competition Order* (para. 702), J.A. 395-396), but also risks associated with the regulatory regime to which a firm is subject. That second consideration is, notwithstanding the incumbents' contrary suggestion (BellSouth Resp. Br. 30-32), implicit in any determination of the true economic cost of capital. See generally *Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exch. Carriers*, 5 F.C.C.R. 7507, 7521 (1990) (para. 120), aff'd *sub nom. Illinois Bell Tel. Co.* v. *FCC*, 988 F.2d 1254 (D.C. Cir. 1993).

of rate regulation—one that has particular resonance in connection with the competitive objectives of the 1996 Act—has always been to "restore the 'true' market price—the price that would result through the mechanism of a truly competitive market." *Farmers Union Cent. Exch., Inc.* v. *FERC*, 734 F.2d 1486, 1510 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984); see *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989) (replacement cost methodologies are appropriately designed to "mimic[] the operation of the competitive market"). The absence of a competitive market is thus no reason to discard ratemaking methodologies that simulate market prices. It is, rather, a justification for using such methodologies.

The incumbents, citing eminent domain cases, assert that "market value may not be used as the basis for compensation in the absence of an objective standard of comparable and reliable market transactions." BellSouth Resp. Br. 38. Those cases, however, provide simply that traditional methods of determining value on the basis of the prices that sellers of comparable goods or services are commanding do not yield a fair or workable measure of just compensation where no market, or no competitive market, exists. In such circumstances, the market prices may be higher than the Just Compensation Clause requires, making it appropriate to determine compensation on another basis that simulates "fair market value" and not "hold-up value." *United States* v. *Cors*, 337 U.S. 325, 334 (1949). That, of course, is an objective of rate regulation as well.

Similarly, there is no merit to the incumbents' suggestion that it is inconsistent with the 1996 Act's deregulatory objectives to require network elements to be priced at rates that a competitive market would yield. Qwest Br. 18-20. The Act, to be sure, is intended to reduce *unnecessary* regulation in order to promote competition, but the Act also intends for the FCC and the state commissions to continue to engage in

necessary regulation, including the enforcement of incumbents' obligations to provide new entrants with interconnection and network elements. Congress did not assume that incumbents would fulfill those obligations without regulatory intervention. See, *e.g.*, 47 U.S.C. 252(b) and (e)(5) (providing for compulsory arbitration of interconnection agreements by state commissions or FCC). And, although Congress authorized the FCC to "forbear" from applying most provisions of the Act if the FCC finds that they are not needed to protect consumers or otherwise to advance statutory goals, 47 U.S.C. 160(a), Congress expressly prohibited the FCC from forbearing with respect to "the requirements of section 251(c) * * * until it determines that those requirements have been fully implemented," 47 U.S.C. 160(d).

In sum, the FCC reasonably found that the statutory requirement that incumbents give new entrants access to their networks at rates "based on the cost of providing the * * * network element," 47 U.S.C. 252(d)(1)(A)(i), is most sensibly implemented by setting rates based on the long-run forward-looking costs of efficient, currently available technology. It is those costs that are relevant to decisions regarding pricing, entry, and investment in competitive markets. *Local Competition Order* (paras. 620, 630, 679, 740), J.A. 327-328, 333-334, 379-380, 422-423; see *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-1117 (7th Cir.) ("[I]t is current and anticipated cost, rather than historical cost, that is relevant to business decisions to enter markets."), cert. denied, 464 U.S. 891 (1983). TELRIC is designed to compensate incumbents for their full forward-looking costs of providing network elements; to enable competitors efficiently to enter the market and to acquire expertise, capital, and a customer base, while providing incentives for them to construct their own facilities where doing so makes economic sense; and ultimately to afford consumers the benefits of retail rates that reflect competitive market pricing. *Local Competition Order* (paras. 307, 620, 679, 682-688), J.A. 299-300, 327-328, 379-380, 381-386; see *Implementation of the Local Competition Provisions in the Telecomms. Act of 1996* (*UNE Remand Order*), 15 F.C.C.R. 3696, 3701, 3749 (1999) (paras 7, 112), petitions for review pending *sub nom. United States Telecom Ass'n* v. *FCC*, No. 00-1015 (D.C. Cir. Jan. 19, 2000). The FCC's decision to adopt TELRIC was a reasonable policy choice on a matter that Congress left to the expert agency to resolve. See *Chevron*, 467 U.S. at 842-845.

II. THE FCC'S COMBINATIONS RULES ARE ENTITLED TO *CHEVRON* DEFERENCE

A. The challenge to the Eighth Circuit's invalidation of Rules 315(c)-(f) has not been waived

The incumbents renew their argument, which they raised at the petition stage, that petitioners "abandoned" or "waived" any challenge to the Eighth Circuit's invalidation of the combinations rules, 47 C.F.R. 51.315(c)-(f), by not raising such a challenge in *Iowa Utilities Board I*. See BellSouth Resp. Br. 41-43. This Court, however, granted certiorari in these consolidated cases to review the Eighth Circuit's holding with respect to Rules 315(c)-(f), notwithstanding the incumbents' argument that the question had not been properly preserved.

Nor did the Eighth Circuit treat its decision in *Iowa Utilities Board I* as precluding its reconsideration of the validity of Rules 315(c)-(f). On remand from this Court's decision, the Eighth Circuit ordered briefing on whether, "in light of the Supreme Court's decision, this court should take any further action with respect to * * * § 51.315(c)-(f) (unbundling rules)." Order at 2-3 (June 10, 1999) (No. 96-3321 & consolidated cases). Subsequently, the Eighth Circuit, without invoking the doctrine of waiver, issued a new decision invalidating Rules 315(c)-(f) on the merits, albeit for

the same reasons stated in *Iowa Utilities Board I*. See U.S. Pet. App. 26a-29a. No authority precludes the Court from reviewing that decision at this time. Indeed, the question has taken on added significance since *Iowa Utilities Board I*, given the circuit conflict that has arisen as to whether Section 251(c)(3) precludes the adoption of such combinations requirements. See U.S. Pet. 27-28.[9]

B. Rules 315(c)-(f) are the product of an expert agency's reasonable construction of ambiguous statutory language

Rules 315(c)-(f) require incumbents to combine elements that are currently not combined in their networks, if a new entrant requests the combination and compensates the incumbent for providing it. The Eighth Circuit held that those Rules "violate the plain language" of 47 U.S.C. 251(c)(3), which it construed as requiring new entrants, rather than incumbents, to combine such elements. That view is mistaken. Section 251(c)(3), which states that "[a]n incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements," is ambiguous as to

[9] The incumbents' reliance (BellSouth Resp. Br. 42-43) upon *Communist Party* v. *Subversive Activities Control Board*, 367 U.S. 1 (1961), is misplaced. In that case, the Court held that, in challenging agency orders, private parties may not "withhold in this Court and save for a later stage procedural error" that could "make waste" more than "ten years of litigation;" the Court explained that permitting such tactics would lead to unnecessary "expenditures of agency time" on remand and would "foist upon the Court constitutional decisions which could have been avoided had those errors been invoked earlier." *Id.* at 31-32 & n.8. No similar circumstance exists here. The government itself has sought review of the decision at issue, so any concern about "expenditures of agency time" is absent; the claim presented is not a procedural issue antecedent to a constitutional issue that the Court might have sought to avoid; and the lower courts now have split on the consequences of this Court's previous decision, such that the need for the Court's intervention is now obvious.

whether incumbents may be required to combine elements. The FCC reasonably resolved the question by requiring incumbents to combine elements in circumstances where they can do so more efficiently than new entrants, *i.e.*, where the new entrant, rather than combining the elements itself, elects to compensate the incumbent for doing so.

1. The incumbents, in seeking to defend the Eighth Circuit's holding that Rules 315(c)-(f) are invalid under step one of the *Chevron* analysis, argue that Section 251(c)(3) "envision[s] that competitors, not incumbents, would be responsible for combining elements for their own use." BellSouth Resp. Br. 44. The incumbents read too much into the statutory text.

Section 251(c)(3) does, to be sure, give new entrants the right to combine unbundled elements in an incumbent's network. But nothing in Section 251(c)(3) gives incumbents the right to refuse to combine such elements, even when the new entrant will pay the incumbent to have the elements provided in combined, rather than unbundled, form. As the FCC recognized, "[t]he phrase 'allows requesting carriers to combine them' [in Section 251(c)(3)] does not impose the obligation of physically combining elements exclusively on requesting carriers," but instead allows that obligation to be imposed on either new entrants or incumbents, or both. *Local Competition Order* (para. 294), J.A. 296-297.

The FCC's reading of Section 251(c) is consistent with this Court's reading of that same provision in *Iowa Utilities Board I*. There, the Court rejected a similar "plain language" challenge to Rule 315(b), 47 C.F.R. 51.315(b), which prohibits an incumbent from disconnecting already combined elements if the new entrant requests the elements in combined form. The Court explained that Section 251(c)(3) "does not say, or even remotely imply, that elements *must*

[never] be provided [by incumbents] * * * in combined form." 525 U.S. at 394.[10]

2. The incumbents attempt to distinguish this Court's earlier decision on the ground that Rule 315(b) was designed to prevent "sabotage" by incumbents and thus serves the requirement of Section 251(c)(3) that access to network elements be provided on "just, reasonable, and nondiscriminatory" terms. See BellSouth Resp. Br. 44. That argument has no bearing on whether the plain language of Section 251(c)(3) forecloses the FCC from requiring incumbents to combine elements in their networks. Moreover, Rules 315(c)-(f), like Rule 315(b), reasonably advance Congress's purpose of assuring "just, reasonable, and nondiscriminatory" access to network elements, because they prevent incumbents from erecting barriers to new entrants' use of network element combinations that incumbents themselves would not encounter. See U.S. Pet. Br. 40-42. Indeed, the FCC justified Rules 315(c)-(f) as necessary to prevent new entrants from being "seriously and *unfairly* inhibited in

[10] The incumbents assert that the FCC "previously stated unequivocally that [Rules 315(c)-(f)] do not present the same question that the Court addressed in *Iowa Utilities Board*" with respect to Rule 315(b). BellSouth Resp. Br. 45. That assertion, while of no particular significance to the merits here, warrants clarification. After the Eighth Circuit's 1997 decision in *Iowa Utilities Board I* invalidating Rules 315(c)-(f), the FCC opposed rehearing petitions that sought to extend that decision to Rule 315(b). The FCC argued that "the [Eighth Circuit's] rationale" for invalidating Rules 315(c)-(f) did not require the invalidation of Rule 315(b). Response of Federal Respondents to Petitions for Rehearing at 9 (Oct. 1, 1997) (No. 96-3321 & consolidated cases). The Eighth Circuit disagreed and invalidated Rule 315(b) on rehearing. This Court reversed. We have since consistently maintained that *this Court's* rationale in *Iowa Utilities Board I* for upholding Rule 315(b) also supports upholding Rules 315(c)-(f). See, *e.g.*, *UNE Remand Order*, 15 F.C.C.R. at 3909 (para. 481) ("As a general matter, however, we believe that the reasoning of the Supreme Court's decision to reinstate rule 51.315(b) based on the nondiscrimination language of section 251(c)(3) applies equally to rules 51.315(c)-(f).").

their ability to use unbundled elements to enter local markets." *Local Competition Order* (para. 293), J.A. 295-296 (emphasis added). Thus, although, as the incumbents note (BellSouth Resp. Br. 46), the FCC did not "cite Section 251(c)(3)'s nondiscrimination ban in the relevant portions of its *Order*," the FCC's justification for Rules 315(c)-(f), in those very portions of the *Order*, demonstrates the FCC's concern with protecting against "unfair" practices of incumbents against new entrants.[11]

The incumbents claim that it is not discriminatory for an incumbent to force a new entrant to use its own workforce and its own resources to combine elements in the incumbent's network. See BellSouth Resp. Br. 45. The FCC, however, reasonably concluded otherwise. The FCC recognized that a new entrant is not "on an equal footing" (*ibid.*) with an incumbent in such circumstances, because the new entrant may often lack the "facilities and information about the incumbent's network" to perform the combinations as efficiently as the incumbent, if at all. *Local Competition Order* (para. 293), J.A. 295-296; see also U.S. Pet. Br. 42-44 (discussing incumbents' practices since the invalidation of Rules 315(c)-(f) that impede new entrants' ability to combine network elements).

3. The incumbents further contend that the FCC, in the *Local Competition Order*, offered the same justification for Rules 315(c)-(f) as it did for other rules that have been invalidated by this Court or the Eighth Circuit. For example, the incumbents argue that the FCC "required blanket access to network elements on the theory that Section

[11] The incumbents are thus mistaken in suggesting (see BellSouth Resp. Br. 46 and n.37) that the FCC is now seeking to justify Rules 315(c)-(f) on grounds different from those advanced in its *Local Competition Order*. See *UNE Remand Order*, 15 F.C.C.R. at 3909 (para. 481) (reflecting FCC's understanding that Rules 315(c)-(f) are grounded in "the nondiscrimination language of section 251(c)(3)").

251(c)(3) impose[s] on an incumbent LEC the duty to provide all network elements for which it is technically feasible to provide access," that the FCC offered the same theory to justify Rules 315(c)-(f), and that the Court rejected that theory in invalidating Rule 319, 57 C.F.R. 51.319, in *Iowa Utilities Board I*. See BellSouth Resp. Br. 46. The incumbents' argument rests on an erroneous premise. The FCC did *not* offer the same rationale for Rules 315(c)-(f) as for Rule 319; rather, as explained, the FCC adopted Rules 315(c)-(f) to assure that network elements are available to incumbents on "just, reasonable, and nondiscriminatory" terms, 47 U.S.C. 251(c)(3). That the Court invalidated a different rule, which addressed a different subject and rested on a different rationale, provides no basis for invalidating Rules 315(c)-(f).[12]

For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed insofar as it vacated 47 C.F.R. 51.505(b)(1) and 47 C.F.R. 51.315(c)-(f).

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

JULY 2001

---

[12] Similarly, the incumbents claim (BellSouth Resp. Br. 46-47) that Rules 315(c)-(f) are "a species of superior-quality regulation," which the Eighth Circuit has invalidated and which are not at issue here. Again, the FCC's rules regarding the quality of network elements that incumbents must provide, set forth in Rule 311(c), 47 C.F.R. 51.311(c), are distinct from Rules 315(c)-(f), which address who may be required to combine network elements.

JUL 23 2001

(23)

No. 00-511

Supreme Court, U.S.
FILED
JUL 23 2001
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *et al.*,

Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION and the UNITED STATES OF AMERICA,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR PETITIONERS

MARK L. EVANS
MICHAEL K. KELLOGG
KELLOGG, HUBER, HANSEN, TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Road
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

July 23, 2001 *(Additional Counsel Listed on Inside Cover)*

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

30 pp

ANDREW G. MCBRIDE
SCOTT DELACOURT
KRISTINA R. OSTERHAUS
WILEY REIN & FIELDING LLP
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

HENRY WEISSMANN
MUNGER, TOLLES & OLSON LLP
355 S. Grand Avenue
Los Angeles, CA 90071
(213) 683-9100

Counsel for Verizon Entities

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, TX 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States Telecom Association

STATEMENT PURSUANT TO RULE 29.6

Petitioners' Rule 29.6 Statements were set forth at pages ii-iii of Petitioners' Opening Brief, and there are no amendments to those Statements.

TABLE OF CONTENTS

	Page
STATEMENT PURSUANT TO RULE 29.6	i
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iii
I. THE 1996 ACT DOES NOT PERMIT THE FCC TO IGNORE HISTORICAL COSTS	1
II. TELRIC RAISES SERIOUS CONSTITUTIONAL QUESTIONS UNDER *DUQUESNE*	4
III. NOTHING ABOUT THE ORDER'S "TOTAL EFFECT" CURES TELRIC'S SHORTFALL ..	10
IV. THE AGENCY'S SELECTION OF TELRIC WAS ARBITRARY AND CAPRICIOUS	17
CONCLUSION	20

TABLE OF AUTHORITIES

Cases	Page(s)
ALLTEL Corp. v. FCC, 838 F.2d 551 (D.C. Cir. 1988)	12
AT&T Corp. v. Iowa Utilities Board, 525 U.S. 366 (1999)	16, 19
Blanchette v. Connecticut General Insurance Corps., 419 U.S. 102 (1974)	10
Brooks-Scanlon Co. v. Railroad Commission, 251 U.S. 396 (1920)	13
Citizens Utility Board v. Illinois Commerce Commission, 655 N.E.2d 961 (Ill. App. Ct. 1995) ..	8
City of Detroit v. Detroit Citizens' Street Railway, 184 U.S. 368 (1902)	7
City of Lafayette v. Louisiana Power & Light Co., 435 U.S. 389 (1978)	10
Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989)	4, 8, 9, 10
Eastern Enterprises v. Apfel, 524 U.S. 498 (1998) ..	8
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944)	8
Field v. Mans, 516 U.S. 59 (1995)	3

	Page(s)
General Motors Corp. v. Tracy, 519 U.S. 278 (1997)	7
In re Permian Basin Area Rate Cases, 390 U.S. 747 (1968)	12
Kaiser Aetna v. United States, 444 U.S. 164 (1979)	8
Michigan Bell Telephone Co. v. Engler, No. 00-2087, 2001 WL 788359 (6th Cir. July 13, 2001)	13
National Ass'n of Greeting Card Publishers v. USPS, 462 U.S. 810 (1983)	3
Potomac Electric Power Co. v. ICC, 744 F.2d 185 (D.C. Cir. 1984)	3
Preseault v. ICC, 494 U.S. 1 (1990)	10, 12
Russell v. Sebastian, 233 U.S. 195 (1914)	7
Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930)	13
Smyth v. Ames, 169 U.S. 466 (1898)	9
Sweet v. Rechel, 159 U.S. 380 (1895)	10
United States v. Dow, 357 U.S. 17 (1958)	10
United States v. Winstar Corp., 518 U.S. 839 (1996)	8
United States Gypsum, Inc. v. Indiana Gas Co., 735 N.E.2d 790 (Ind. 2000)	8

Constitutional Provisions and Statutes	Page(s)
Takings Clause, U.S. Const. amend. V	9, 12
10 U.S.C. § 2688(e)(1)(A)	1
12 U.S.C. § 1713(c)(2)	1
47 U.S.C. § 213(b)	1
47 U.S.C. § 251	14
47 U.S.C. § 252(d)(1)	14
47 U.S.C. § 252(d)(1)(A)(i)	1
47 U.S.C. § 254(d)-(f)	14
Administrative Agency Orders	
Amendment of Rules and Policies Governing Pole Attachments, 15 F.C.C.R. 6453 (2000)	19
In re 1998 Biennial Regulatory Review, 15 F.C.C.R. 242 (1999)	6
In re Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, 12 F.C.C.R. 15982 (1997)	3, 14
In re Access Charge Reform, Sixth Report & Order, 15 F.C.C.R. 12962 (2000)	15

Page(s)

In re Formal Investigation To Examine and Establish Updated Universal Service Principles and Policies for Telecommunications Service in the Commonwealth, No. I-940035, 1994 Pa. PUC LEXIS 15 (May 4, 1994) 8

In re a Methodology to Determine Long Run Incremental Cost, No. U-10620, 156 P.U.R.4th 1 (Mich. PSC Sept. 8, 1994) 18

In re MFS Intelenet of Maryland, Inc., 86 Md. PSC 467, No. 8584, Phase II (Dec. 28, 1995) 3

In re Michigan Telecommunications Act, No. U-11103, 1996 WL 765369 (Mich. PSC Dec. 12, 1996) 3

Verizon Petitions for Pricing Flexibility for Special Access, 16 F.C.C.R. 5876 (2001) 14

Legislative Materials

H.R. Conf. Rep. No. 104-458 (1996) 19

H.R. Rep. No. 104-204 (1995) 4, 19

Texts and Treatises

Black's Law Dictionary (7th ed. 1999) 1

Alfred E. Kahn, *Whom the Gods Would Destroy, or How Not to Deregulate* (2001) 18

Miscellaneous **Page(s)**

FCC, Common Carrier Bureau, Industry Analysis Division, Local Telephone Competition: Status as of December 31, 2000 (FCC May 21, 2001), *at* <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0501.pdf> ... 6, 16

Postal Rate Commission, No. R80-1, Opinion (1981) .. 3

Verizon ARMIS 43-01 Report (2000), Table 1, Col. H, Row 1920, *at* <http://www.fcc.gov/ccb/armis> 16

I. THE 1996 ACT DOES NOT PERMIT THE FCC TO IGNORE HISTORICAL COSTS.

The FCC claims that the word "cost" can easily connote a price that would be paid today rather than the amount that was paid or charged in the past. FCC Br. 18. The FCC misses the point.

The term "cost" must be construed in the context of *this statute*. The statute does not set a standard of compensation for a new network yet to be built. Rather, it conscripts a particular set of *existing* assets already built by incumbents. Congress was well aware that incumbents were in the midst of recovering the large capital costs associated with these existing assets through retail rates. Precisely because it was not writing on a clean slate, Congress understood that any compensation mechanism had to address not just forthcoming investment but *investment already made*. For this reason, Congress supplemented the general command that rates be "just and reasonable" with the additional directive that rates "shall be . . . based on *the cost* . . . of providing *the* . . . network element," 47 U.S.C. § 252(d)(1)(A)(i) (emphasis added). Unless mere surplusage, this requirement must *delimit* the FCC's discretion beyond the general call for just and reasonable rates. The only sensible understanding of this provision is that it requires recovery of *all costs* reasonably incurred in supplying UNEs, which here must include past investment.[1]

Where "cost" is used to refer to a large capital asset that an owner has *already built*, the natural connotation includes the amount that the owner has actually expended. That connotation is inescapable where, as here, the term is used to refer to assets for which there is

---

[1] AT&T misleads the Court when it suggests that *Black's Law Dictionary* attributes an exclusively forward-looking meaning to the word "cost." *See* AT&T Br. 17-18 (quoting *Black's Law Dictionary* 349-50 (7th ed. 1999)). The cited definition actually pertains to "replacement cost," and, in fact, the definition of "cost" alone focuses on "the amount paid or charged for something." *Black's Law Dictionary* 349. Limiting adjectives must be used to exclude past expenditure from the plain meaning of "cost." *See, e.g.*, 47 U.S.C. § 213(b) ("reproduction cost"); 10 U.S.C. § 2688(e)(1)(A) ("economic cost"); 12 U.S.C. § 1713(c)(2) ("replacement cost").

no ready market. If Congress had set tolls to recover "the cost of providing the interstate highway system," one would readily understand that phrase to refer to amounts expended to build the existing system, not the virtual costs of redesigning and rebuilding it from scratch today. And if Congress had further provided for an additional "profit" to be included in those tolls, it would be beyond dispute that "cost" must encompass all past expenditures. *See* Verizon Pet. Br. 20-21. Contrary to the FCC's current claim, FCC Br. 22-23, its Order concedes that, "in plain English," a "profit" *presumes* the full recovery of all past expenditures. J.A. 393 (¶ 699).

Moreover, at the time Congress acted, the term "cost" had a settled, technical meaning in the context of telephone utility ratemaking. For over 50 years, "cost" had meant the amount actually expended, *i.e.*, historical cost. As the FCC itself acknowledged shortly before the 1996 Act was passed, historical cost was by then the "normal" and "traditional" ratemaking method. *See* Verizon Pet. Br. 20. It is inconceivable that, in selecting this term, Congress meant to authorize the exclusion of historical cost. The FCC's claim that, by 1996, state regulators were using replacement cost as the sole measure of recoverable costs, *see* FCC Br. 21 (citing J.A. 334-36, 381 (¶¶ 631, 681)), is plainly erroneous. In fact, none of the States cited by the FCC had used forward-looking costs as a price ceiling to preclude recovery of historical costs.[2] Rather, the

[2] In its Order, the FCC cited 14 States that supposedly "already employ[ed], or ha[d] plans to utilize," or merely "support[ed] the use of" "some form" of forward-looking pricing (or LRIC methodology) for UNEs. J.A. 334-36, 381 (¶¶ 631, 681 & nn.1508-12, 1687). But at least seven of these States had used or considered forward-looking pricing only to set price floors to police predatory pricing, *see* J.A. 335 (¶ 631 n.1509) (Colorado, Hawaii, Louisiana, Washington, and Wisconsin use LRIC "as a price floor"); J.A. 381 (¶ 681 n.1687) (Florida TSLRIC "may be appropriate . . . for a price floor"); J.A. 113 (Ohio Comm'n Comments at 47) (LRIC "establish[ed] a price floor for competitive service offerings"). Three other States had not yet decided what role forward-looking costs would play in UNE prices, *see* J.A. 115 (Tex. Comm'n Comments at 26) ("regulators cannot begin to answer pricing questions until incremental cost studies on unbundled network elements are completed and we more precisely quantify the disparity

(Cont'd)

real experience of States in using forward-looking costs was as a tool for determining price *floors* to guard against predatory pricing, or as a device for allocating historical costs among customers — not as a mechanism for denying recovery of historical costs. Nor do price caps represent a departure from historical costs. *See id.* at 31. Rather, price caps are a type of historical cost methodology, *see* Verizon Pet. Br. 3-4, as the FCC has acknowledged in other proceedings, *see In re Access Charge Reform*, 12 F.C.C.R. 15982, ¶ 27 (1997).[3]

(Cont'd)

between embedded and incremental costs"); J.A. 57 (Ariz. Comm'n Comments at 12) (Exhibit V consists only of *proposed* rules); J.A. 334-36 (¶ 631 & n.1510) (Oklahoma had merely "provide[d] for submission of LRIC cost studies"). Three additional States had expressed support for forward-looking measures, but had yet to set UNE prices based on forward-looking costs, *see* J.A. 97 (Cal. Comm'n Comments at 29) ("The CPUC has not yet set its prices for the unbundled elements."); *In re Mich. Telcomms. Act*, No. U-11103, 1996 WL 765369, at *1-*2 (Mich. PSC Dec. 12, 1996) (reviewing staff proposal for determining TSLRIC); *In re MFS Intelenet of Md., Inc.*, 86 Md. PSC 467, No. 8584, Phase II, § II.B (Dec. 28, 1995) (adopting interim UNE rates that, in the aggregate, were based on the incumbent's historical costs). Finally, Connecticut adopted a pricing methodology that took the "existing network and *cost structure* as a given," J.A. 100 (Conn. Comm'n Comments, Att. C at 9-10 (emphasis added)). Moreover, even if some aberrant State had disallowed historical cost recovery prior to 1996, just as in the common law, it is the widely-accepted understanding and usage that governs. *See Field v. Mans*, 516 U.S. 59, 71 n.9 (1995) (looking to "the dominant consensus of common-law jurisdictions rather than the law of any particular State").

[3] The two cases showcased by Respondents as "replacement cost" cases, *see* FCC Br. 19-20 & nn.9, 11; AT&T Br. 19-20, actually involved historical cost recovery. In *Potomac Elec. Power Co. v. ICC*, 744 F.2d 185, 193 (D.C. Cir. 1984), the court approved the use of stand-alone replacement cost because it was higher than historical cost and thus enabled the railroad to recover its fully-allocated historical investment. In *National Ass'n of Greeting Card Publishers v. USPS*, 462 U.S. 810, 821 (1983), the Postal Service had "responsibility for guaranteeing that total revenues equal total costs," which it had discharged by providing for *full* recovery of *historical* costs. *See* Postal Rate Comm'n, No. R80-1, Opinion at 13-14 (1981). The case involved only the meaning of "attributable cost" as a guide to cost allocation — not "cost" as a standard for overall cost recovery. 462 U.S. at 827-28.

Finally, Congress knew incumbents were recovering past investment through retail rates and expressed its intent that pricing of wholesale services *should not disrupt* existing cost-recovery mechanisms. *See* H.R. Rep. No. 104-204, at 72 (1995). The FCC offers no explanation why the statute would negate that approach in setting compensation for the network elements used to generate wholesale services.[4]

II. TELRIC RAISES SERIOUS CONSTITUTIONAL QUESTIONS UNDER *DUQUESNE*.

In *Duquesne*, this Court upheld a small adjustment within an historical cost regime only after finding that it still preserved the utility's opportunity to fully recover previously invested capital. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312, 315 (1989). In contrast, TELRIC deprives incumbents of the ability to recover their historical costs, and therefore does not satisfy this standard — a point the FCC concedes by arguing that the standard applied in *Duquesne* was "sufficient, but not necessary" to that decision. FCC Br. 30. Even if the FCC's attempt to rewrite the holding of the case were successful, it would compel this Court to address the "serious constitutional questions" identified in *Duquesne*. *See* 488 U.S. at 315; *see also id.* at 317 (Scalia, J., concurring.). Under principles of constitutional avoidance, the statute cannot be construed to authorize a shift in methodology that requires the Court to resolve these constitutional issues. None of the FCC's tactics to sidestep the constitutional issues is availing.

1. The FCC's feigned agnosticism as to whether TELRIC is higher or lower than historical costs is nonsense. *See* FCC Br. 16-17 & n.8, 37 & n.27. It is indisputable that TELRIC costs are lower than historical costs and thus that UNE rates will not

[4] AT&T incorrectly argues that allowing the incumbent to recover past prudent investment would somehow be "discriminatory." *See* AT&T Br. 23-24. Requiring all users of the network, including wholesale users, to share these real costs in proportion to their use of the network is not "discriminatory." Nor does the argument that the verb "providing" connotes the cost of buying the facility today fare better. *See* FCC Br. 19; AT&T Br. 18. The term "providing" ensures inclusion of operating expenses and costs unique to the provision of UNEs.

permit recovery of past investments. The FCC's own projections are decisive on this point. In the very Order at issue, in setting "proxy prices," the FCC projects the results of TELRIC, J.A. 425-33 (¶¶ 790-798), explaining that these prices "approximat[e]" the results of TELRIC and are so accurate that they should be presumptive ceilings, J.A. 425-26 (¶ 790). The Order projects TELRIC costs that are 60% lower than incumbents' historical costs.[5] Nor could TELRIC have any other consequence, given its assumptions of a hypothetically optimal network coupled with existing cost of capital and depreciation schedules. *See* ILEC Resp. Br. 25-33. Incumbents made submissions demonstrating that blank-slate forward-looking methodologies, including those advanced by entrants, resulted in a substantial revenue gap. *See* J.A. 363-64 (¶ 658). But the FCC rejected the use of historical costs precisely because historical costs yield higher UNE rates than TELRIC, J.A. 383, 398-400 (¶¶ 684, 705, 706).

In its companion Universal Service proceeding, moreover, the FCC corroborated the magnitude of this gap as it determined that TELRIC produces a cost for building the entire local exchange infrastructure — $180 billion — that is barely one-half of incumbents' historical investment of $342 billion. Verizon Pet. Br. 10-11 & n.6. Notably, the FCC, unlike its confused supporters,[6]

[5] Because incumbents' overall retail revenues were set to recoup historical costs, their historical costs can be fairly approximated by gross revenues minus retailing costs. *See* Verizon Pet. Br. 10 n.4. Thus, the FCC's criticisms based upon cross-subsidies among individual rates and the inclusion of retailing costs are irrelevant. *See* FCC Br. 37 n.27.

[6] AT&T and WorldCom make an elementary conceptual error in comparing TELRIC's total construction cost to the unrecovered portion of incumbents' actual investments. *See* AT&T Br. 9-10; WorldCom Br. 29-30. The relevant figures for comparison are annual depreciation expenses. Because TELRIC retains existing depreciation schedules, a network that costs $342 billion will have annual depreciation expenses roughly double those of a network that costs $180 billion. For example, if one assumes straight-line depreciation over 10 years, the first network would result in $34 billion per year of depreciation expenses and the TELRIC network would result in only $18 billion. TELRIC thus cuts incumbents' cost recovery in half.

does not dispute the magnitude of the gap shown by these figures (except to make the empty assertion that the Universal Service proceeding is "distinct," FCC Br. 36-37).[7] In any event, the precise magnitude of the shortfall is irrelevant here. All that is relevant is that TELRIC was projected to result in a systematic shortfall.

This case thus involves an ever-expanding removal of prudent capital investment in used and useful plant from an existing regime that allows its recovery to a new regime that categorically denies its recovery. *Each UNE taken* results in the movement of half of the incumbent's embedded investment from the recoverable to the unrecoverable side of the ledger. The prudent investment excluded by this regime is open-ended and already substantial. Incumbents had already lost 5.3 million lines nationwide as of year-end 2000, and this number was increasing at a 257% annual growth rate.[8] Half the remaining capital investment in these facilities already has been stranded. In fact, the losses are even larger. Because 20% of local telephone customers generate 80% of revenues, even a 5% line loss can produce a revenue loss of 20%. But the magnitude of facilities ultimately shifted to UNEs is irrelevant; the "take rate" goes only to *how much* recovery is precluded, not to *whether* recovery is precluded. From a constitutional standpoint, what is relevant is that TELRIC denies recovery of prudent capital investment, whatever the scale of the plant ultimately shifted.

[7] The FCC makes a different error. Contrary to its statement in the Order under review, J.A. 364-65 (¶ 659 n.1633), the FCC now contends that "incumbents' facilities are, as a general matter, no longer underdepreciated," FCC Br. 38. In fact, the very source that the FCC cites for this proposition acknowledges that, if incumbents were allowed to use the same depreciation lives for regulatory purposes that they use for financial reporting, "they could immediately show over $34 billion in apparent depreciation reserve deficiencies." *See In re 1998 Biennial Regulatory Review*, 15 F.C.C.R. 242, ¶ 64 (1999).

[8] *See Local Telephone Competition: Status as of December 31, 2000*, at 2 & Table 4 (FCC May 21, 2001) ("*Local Competition Status*"), *at* <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0501.pdf>.

2. The FCC's core argument is that incumbents have no right to recover prudent past investment. In its Order and Brief, the FCC asserts that incumbents are due only the "fair market value" of their facilities and that TELRIC provides this by predicting what those facilities would be worth in a competitive market. J.A. 422-23 (¶ 740); FCC Br. 35-36. In the agency's view, the fact that TELRIC denies recovery of past investment is "of no constitutional significance." FCC Br. 29. The FCC's argument here — that TELRIC standing alone is an adequate measure of compensation — is conceptually distinct from its later argument, refuted in Section III *infra*, that TELRIC's shortfall is otherwise cured by the Order's "total effect." Here, the FCC must show that TELRIC would yield a constitutionally sufficient return if it were applied to an incumbent's entire business, or, to like effect, to the UNE business "in isolation." FCC Br. 13, 14, 33, 35-36. As shown below, the FCC's argument is devoid of merit. But, at a minimum, the Court would be required to break new constitutional ground to uphold the radical methodological switch embodied in TELRIC.

a. The FCC invokes the commonplace that ratemaking agencies have broad discretion. But this is not a case about the agency's methodological latitude *before* investment is made, where investors are free to invest or not, and are being paid in advance for any risk of non-recovery. This case concerns the propriety of a shift in methodologies *after* investment has been made, where investors have never been paid for any risk of non-recovery.

The basic terms of the regulatory compact are well settled. Where the government has induced investors to dedicate capital to an ongoing utility enterprise, it has created (explicitly or implicitly) reasonable, investment-backed expectations that rates will be set to provide an opportunity to recover capital and a reasonable return. *See, e.g.*, *General Motors Corp. v. Tracy*, 519 U.S. 278, 294-97 (1997); *Russell v. Sebastian*, 233 U.S. 195, 204 (1914); *City of Detroit v. Detroit Citizens' Street Ry.*, 184 U.S. 368, 384 (1902). Without that governmental quid pro quo, the massive investments and service obligations undertaken by utilities

would be economic "madness." *See United States v. Winstar Corp.*, 518 U.S. 839, 910 (1996) (plurality opinion). Many States have *expressly* acknowledged the binding nature of this regulatory bargain.[9] This Court has vindicated expectation interests based on significantly less formal relationships with the government. *See, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 179-80 (1979).

Thus, fair market value has no application here. *See* Verizon Pet Br. 26-31. As *Duquesne* recognizes, once investment has been induced under rules that promise a fair opportunity to recover capital, investors have a legitimate expectation that they will have that opportunity. The harsh retroactivity of a midstream shift is manifest: the public has reaped all the benefits of lower, stable rates, while investors were never paid for the risk that recovery would be based on the continuous revaluation of assets rather than on the steady value of dedicated capital. The FCC is acting like a car owner who waltzes into a bank and tells the loan officer that henceforward his monthly payments will be based only on the Blue Book value of his car, rather than on the amount of capital he borrowed. *See Eastern Enters. v. Apfel*, 524 U.S. 498, 548 (1998) (Kennedy, J., concurring in the judgment).

Further, no business can live on TELRIC alone. It is not "sufficient to assure confidence in the financial integrity" of the UNE business, "so as to maintain its credit and to attract capital." *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). No rational investor would take a debt or equity stake in an incumbent's "UNE business" — an enterprise doomed to continuing write-offs of prudent capital investment, enormous regulatory risks,

[9] *See, e.g., United States Gypsum, Inc. v. Indiana Gas Co.*, 735 N.E.2d 790, 797 (Ind. 2000) ("The bedrock principle behind utility regulation is the so-called 'regulatory compact' which arises out of a 'bargain' struck between the utilities and the state."); *Citizens Util. Bd. v. Illinois Commerce Comm'n*, 655 N.E.2d 961, 971 (Ill. App. Ct. 1995) ("[W]e are . . . aware of the special rights and obligations arising from the regulatory compact between the public and investor owned utilities."); *In re Formal Investigation*, No. I-940035, 1994 Pa. PUC LEXIS 15, at *1 (May 4, 1994) ("the regulatory compact [was] struck between the industry and government in the early part of the 20th century").

and depreciation schedules and a rate of return appropriate to a closed market.

b. Besides its inapplicability, the FCC's "fair market value" argument fails because there is, in fact, *no market*. TELRIC is an entirely imaginary construct based on speculation about a non-existent market and network. If the Fifth Amendment's "just compensation" guarantee is to have any meaning, it must refer to an objective standard, independent of the government's self-interested opinion. It turns the constitutional safeguard on its head to permit the government to conjure up and dictate an imaginary "market value" where no market exists. *See* ILEC Resp. Br. 38-41.

This Court has never suggested that imaginary "replacement cost" can be treated as a real market value and used as the sole determinant of cost recovery. Contrary to Respondents' implication that the old "fair value" test is a synonym for replacement cost, *see* FCC Br. 19-20 & n.10; AT&T Br. 30-31, this Court stressed that replacement cost analysis could be only one factor and that historical and opportunity costs had to be given due weight. The "value" that was "fair" was expressly *not* replacement cost by itself. *Smyth v. Ames*, 169 U.S. 466, 546-47 (1898). But the FCC has made its hypothetical modeling the sole determinant of compensation and untethered it from any objective measure of cost by imagining a blank-slate redesigned network. *See infra* n.15. This leaves the Court with no standard to determine whether compensation is just. *See Duquesne*, 488 U.S. at 317 (Scalia, J., concurring).

c. The FCC's remaining constitutional arguments are makeweights. First, it implausibly claims that there is no "switch" here because the compelled lease of UNEs is a "new" business. FCC Br. 31-32. But UNEs are *not* "new" facilities. They are the same facilities whose historical costs incumbents had been recovering through retail rates. For each UNE taken, there is a shift in the method of cost recovery. Second, the FCC alludes to provisions of the 1996 Act under which prior restrictions on long-distance competition must be lifted if an incumbent shows that it has eliminated competitive concerns by fully opening its local markets. *Id.* at 32. The claim seems to be that this is a gift

the FCC may offset by undercompensating incumbents for their UNEs. But once incumbents have removed the basis for the prior restriction, they have the same right to compete as any other company. The right to participate in competitive markets is "the fundamental principle governing commerce in this country," *City of Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389, 398 (1978), not a governmental gift. Even if it were a "gift," any quid pro quo must be defined in the statute itself — which plainly is not the case here.

III. NOTHING ABOUT THE ORDER'S "TOTAL EFFECT" CURES TELRIC'S SHORTFALL.

The FCC projected that TELRIC would result in rates insufficient to recover incumbents' past investment, and rejected every proposal to address this shortfall on the ground that incumbents were not entitled to those costs. To avoid the principles recognized in *Duquesne*, the FCC now argues that, even if UNE rates are non-compensatory, the Order's "total effect" cures TELRIC's deficiency, because either: (a) Paragraph 739 states that the FCC did not "completely foreclose the possibility" that the FCC *might* address the deficiency later; or (b) Paragraph 737 suggests that other revenues from incumbents' interstate businesses could be "considered." FCC Br. 28, 33-35, 40.

As a threshold matter, both arguments ignore the central mission of an agency in framing a rate methodology. When the government conscripts property, it must make clear and certain provision for adequate compensation *at the time of the taking*.[10] When a utility's property is dedicated to service, the government meets this obligation by clearly declaring at the outset the standard by which the adequacy of compensation shall be measured. Setting this standard is how the government promises

[10] *Preseault v. ICC*, 494 U.S. 1, 11 (1990) ("reasonable, certain and adequate provision for obtaining compensation at the time of the taking" (internal quotation marks omitted)); *Blanchette v. Connecticut Gen. Ins. Corps.*, 419 U.S. 102, 124-25 (1974) (quoting *Cherokee Nation v. Southern Kan. Ry.*, 135 U.S. 641, 659 (1890)); *United States v. Dow*, 357 U.S. 17, 21 (1958); *Sweet v. Rechel*, 159 U.S. 380, 402 (1895).

to pay for using a utility's property. Ratemaking is thus inherently teleological. Verizon Pet. Br. 38. The ratemaker must define the target in advance (the costs to be recovered) and then project that its methodology will achieve this level of recovery. The "total effect" of an order is what the agency has *projected* as an acceptable outcome at the time of its adoption.

A utility can challenge a methodology on the grounds that the outcome the agency projected as acceptable does not meet the constitutional standard. This is the heart of Petitioners' claim. Verizon Pet. Br. 38-39. The agency cannot avoid this constitutional claim by contending that it has not determined what the target of compensation should be or that it is uncertain as to the outcome of its methodology. Just as the government cannot take over someone's living room with vague statements that it "will think about paying," it cannot conscript a utility's property into service based on evasions that it "might consider payment" or that it "will play things by ear."

1. Contrary to the FCC's assertion, FCC Br. 28, nothing in Paragraph 739 retreats from the agency's consistent position that incumbents are not entitled to recover their historical costs. In fact, the Paragraph offers no concession at all. The first sentence says that an incumbent may "seek relief" if it can specifically demonstrate that the rates are "confiscatory." J.A. 422 (¶ 739). But the FCC had just concluded that a rate that prevents recovery of past investment is *not* confiscatory. J.A. 420-21 (¶ 736). On its face, this does not offer even the possibility, much less the assurance, of "relief" from the stranding of historical investment. The second sentence of Paragraph 739 says that the FCC does not "completely foreclose the possibility" of providing "some" recovery. J.A. 422 (¶ 739). This provides no assurance of relief and, even if it did, an after-the-fact remedy is meaningless without a firm commitment to the standard of compensation that will inform its exercise. If the vague musings in Paragraph 739 qualify as "reasonable, certain and adequate provision for obtaining compensation at

the time of the taking," *Preseault*, 494 U.S. at 11, then the Fifth Amendment guarantee is empty.[11]

2. The FCC next claims that, while UNE rates are not sufficient, unspecified "revenue for other services" may be "considered." J.A. 421 (¶ 737). The FCC's Brief claims that incumbents' interstate businesses have "healthy" aggregate returns, suggesting that money must be available as a cross-subsidy to pay for the shortfall on UNEs. FCC Br. 29. This assertion fails on two grounds: (1) reliance on interstate revenues to cross-subsidize inadequate UNE rates is prohibited by the Constitution and the 1996 Act; and (2) the conclusory assertion that other revenues might be available does not satisfy the dictates of reasoned decisionmaking.

A vague allusion to "other revenues" does not constitute an effective cross-subsidy. Where the government insulates a utility from competition, a regulator may set the price of one product below cost as long as it "pays" for the shortfall by *creating* a sufficient cross-subsidy from another product. But to justify below-cost pricing on this ground, two conditions must be met. *First*, the regulator must be responsible for generating a supra-compensatory margin over and above what would otherwise be due on the subsidizing product. Thus, the regulator must actually have the capacity to create

[11] Contrary to AT&T's suggestion, AT&T Br. 28, Paragraph 739 does not remotely resemble the waiver procedure in *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). In *Permian Basin*, there was no dispute that historical cost was the appropriate standard of recovery. The FPC used averages derived from actual cost data from pertinent areas, *id.* at 761, and made a "waiver" available for particular producers to show that their costs exceeded those averages, *id.* at 770-71. The waiver procedure was thus a refinement to reach the *agreed* target of historical cost. Here, the dispute is whether the government has selected the right target. An agency cannot cure a systemic deficiency by vaguely offering the possibility of individual waivers. *See, e.g., ALLTEL Corp. v. FCC*, 838 F.2d 551, 561 (D.C. Cir. 1988). Neither Paragraph 739 nor any other portion of the Order suggests that an incumbent could obtain a "waiver" of TELRIC *because* it denies recovery of historical costs. Further, because the FPC allowed a dissatisfied firm to cease production, 390 U.S. at 772-73 & n.39, *Permian Basin* was a voluntary price ceiling case — not a forced-production case such as this case. *See* ILEC Resp. Br. 36-37.

new incremental revenue — which it does in a closed market — and use that capacity to generate and protect a supra-compensatory margin. *Second*, the regulator must make a reasoned determination that subsidizing revenues are available and adequate, and must calibrate the two revenue pools to ensure sufficient and predictable compensation in both lines of business.

The FCC thus fundamentally misconceives what it means for activities to be "regulated" — *i.e.*, made regular — for purposes of the *Brooks-Scanlon* principle. Contrary to the FCC's assumption, the regulator cannot claim credit for revenues from all activities that it *burdens* with regulation, but only from those activities that it *benefits* by ensuring increased returns.[12] For this reason, a regulator may not rely on competitive revenues or revenues from another sovereign's jurisdiction. *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920); *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133, 160-61 (1930); *Michigan Bell Tel. Co. v. Engler*, No. 00-2087, 2001 WL 788359, at *4 (6th Cir. July 13, 2001) (under *Brooks-Scanlon*, diversified enterprises cannot be "required to subsidize their regulated services with income from rates either deemed to be competitive, or with revenues generated from unregulated services"). Those revenues are already providing the compensation due in those respective lines of business, and the regulator lacks capacity to generate additional margins beyond compensatory levels.

Neither of the two conditions discussed above is remotely satisfied here. The FCC casually refers to the overall returns on incumbents' combined interstate business. FCC Br. 29 & n.17, 34-35. But it plainly violates *Brooks-Scanlon* to rely on overall interstate revenues. Incumbents' interstate businesses are not monolithic, but include lines of business (*e.g.*, long distance,

[12] A government requirement that GM sell Chevrolets below cost cannot be justified by the profitability of Cadillacs, even though the government "regulates" Cadillacs by establishing vehicle safety and emissions standards. Nor could the government claim credit for GM's Cadillac revenues by "regulating" the maximum price that GM can charge for Cadillacs. In neither case is the government responsible for generating the Cadillac revenues.

business data and "special" access) that were competitive well before the 1996 Act. These services comprise a large portion of interstate revenues (some 40% in the case of Verizon). The FCC has formally "deregulated" much of these revenues. *See, e.g.*, *Verizon Petitions for Pricing Flexibility for Special Access*, 16 F.C.C.R. 5876 (2001). Incumbents also face competition on consumer switched access charges (which the FCC still subjects to price caps), particularly with respect to the narrow segment of "high value" customers who disproportionately generate that revenue. In New York, for example, Verizon has already lost more than 25% of its switched access revenue to competitors.

Moreover, the revenue from access charges is already spoken for. Those revenues are unavailable, not only because they are subject to competition, but also because the premise of the 10-year price cap regime is that resultant returns are *compensatory* and yield no "excess." Price caps involve their own regulatory bargain — if the carrier exceeds imputed efficiency levels, it has *earned* a higher rate of return. By definition, that return is necessary to compensate for risks inherent in a price cap regime. *See In re Access Charge Reform*, 12 F.C.C.R. 15982, ¶ 26 (1997). A regime that retroactively declares some of these revenues "excess" and applies them to cover shortfalls elsewhere breaches this bargain. It reduces the return on the access business below the level previously judged compensatory — and leaves no standard to assess the sufficiency of compensation.

The creation of a new cross-subsidy to cover TELRIC's shortfall is also antithetical to the Act. Congress recognized that implicit cross-subsidies are not sustainable in competitive markets and directed their elimination, *see* 47 U.S.C. § 254(d)-(f), and further directed that the UNE business pay for itself, *see id.* § 252(d)(1). Further, UNE rates that rely on cross-subsidies embedded solely in incumbents' prices expose incumbents to cherry picking and therefore violate Section 251's requirement that UNE rates be "non-discriminatory." The notion

that Congress intended incumbents' retail customers to subsidize UNEs for the benefit of competing carriers' shareholders is nonsense.

The FCC's purported reliance on a cross-subsidy is also completely arbitrary, given that the agency has taken the position that any shortfall should be recovered through a "competitively neutral" mechanism that is "separate from rates," FCC Br. 40; J.A. 422 (¶739), such as a non-bypassable end-user charge. Thrusting UNE costs on retail customers — rather than allocating them to UNE users — clearly "warp[s] the course of competition," FCC Br. 40, and is directly contrary to the agency's rationale for excluding them from UNE prices in the first place. *See* J.A. 399-400 (¶706).

Even if cross-subsidies were permissible, calling incumbents' interstate revenues "healthy," FCC Br. 29, in a legal brief is not reasoned decisionmaking. The FCC has not projected how much revenue is needed, identified which *categories* of interstate revenues are available, or determined how much "excess" revenues particular interstate services generate. The last determination would require the agency to arrive at appropriate rates of return for various interstate services now subject to competition. Because the FCC has never made this finding, it has no standard for determining what revenues, if any, are "excess." The retroactive imposition of any particular rate of return on the access business — let alone the 11.25% return established for a monopoly environment — is wholly inconsistent with a price cap regime. Finally, the FCC has never purported to calibrate access charges to cover the burgeoning losses of the UNE business. On the contrary, in its access charge orders, the FCC set access rates without regard to UNE losses and has, in fact, *reduced* access revenues to cover *only* the costs of those services. *In re Access Charge Reform, Sixth Report & Order*, 15 F.C.C.R. 12962, ¶¶ 3, 20 (2000).[13]

---

[13] Even if a cross-subsidy were permissible, the whole pot of interstate revenues is inadequate to compensate for the below-cost UNE

(Cont'd)

The FCC's blithe invocation of the "financial integrity" test is meaningless. As shown above, that standard cannot be applied to a company with diversified lines of business subject to competition and to the jurisdiction of multiple sovereigns, as the FCC attempted to do in Paragraph 738 of its Order. J.A. 421-22 (¶ 738). Nor is the FCC's cause aided by its present claim that it was referring solely to the "financial integrity" of interstate operations.[14] First, as explained above, incumbents' interstate revenues plainly include unavailable competitive revenues. Second, unless and until the FCC defines which interstate lines of business it is relying on to augment UNE rates,

---

(Cont'd)
rates. First, the mounting UNE costs are already huge in relation to the size of overall interstate revenues. Interstate revenues are set to recover 25% of incumbents' total costs. Verizon has already turned over 6% of its lines as UNEs. *See Local Competition Status*, Table 6. Thus, the aggregate "UNE rate base" is already approaching one-quarter the size of the interstate rate base. Second, the aggregate interstate earnings are irrelevant. It is the individual operating companies (which issue their own bonds) that must be able to project earnings satisfactory to the capital markets. The fact that Verizon's New York telephone company has an interstate return — even without consideration of the new "UNE rate base" — of a meager 5.18%, *see* Verizon ARMIS 43-01 Report (2000), Table 1, Col. H, Row 1920, *at* <http://www.fcc.gov/ccb/armis>, refutes the notion that there are "excess" interstate revenues.

[14] In its Order, the FCC categorically stated that it "may not consider incumbent LECs' revenue derived from services not under our jurisdiction." J.A. 421 (¶ 737 n.1756) (citation omitted). One paragraph later, the agency contradicted itself by purporting to consider incumbents' "financial integrity" in all their operations. J.A. 422 (¶ 738). Before this Court, the FCC again plays both sides of this issue. First, it disclaims any reliance on intrastate retail revenues, FCC Br. 34 n.24, but later intimates that incumbents' total revenues from *all* services "could" be counted, *id.* at 35 n.25. Still later, the agency cannot restrain itself from citing "local retail rates" to supplement TELRIC. *Id.* at 38. The FCC was right the first time — it has no jurisdiction over intrastate retail revenues and therefore cannot make them part of an interdependent rate regime. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 381 n.8 (1999).

and what rates of return are appropriate to those businesses, the "financial integrity" test is meaningless and provides no standard for judicial review. More basically, the "financial integrity" test can protect a firm only when it is applied to an entity that is actually raising capital in the market. Only then does the standard provide an objective check on government depredation — the return investors will insist upon before committing capital. Without that check, the "financial integrity" test is an empty slogan that both invites and cloaks theft from other businesses.

IV. THE AGENCY'S SELECTION OF TELRIC WAS ARBITRARY AND CAPRICIOUS.

The FCC's selection of TELRIC in lieu of an historical cost methodology was also arbitrary and capricious.

1. A blank-slate replacement cost methodology is too unworkable and speculative to serve as the exclusive basis for cost recovery. Less radical replacement cost methods had been discredited on precisely these grounds. Only the most arrogant regulator would presume to predict accurately the evolution of the *entire telephone network* in every particular over 30 to 50 years, in the face of unforeseeable technological change. Forward-looking analysis has been used in setting price *floors* or as a method of *allocating* historical costs. In neither context has forward-looking cost been used to limit historical cost recovery. Nor has it involved hypothesizing the redesign of the entire network.

The FCC chose an extreme, blank-slate approach that magnifies these problems. The FCC removes any objective check on TELRIC by prohibiting consideration of opportunity or historical costs. TELRIC then piles speculation on top of hypothesis by assuming the instantaneous deployment of an optimal network. TELRIC exceeds anything ever countenanced by this Court as a reliable measure of recoverable costs.[15]

---

[15] The FCC's version of forward-looking cost is unlike any seen before. A forward-looking methodology is used to ascertain what will actually be spent over the long run. A key to any forward-looking methodology is the baseline configuration of assets assumed in year one. Usually, the inquiry is into the long-run cost of a defined *increment* of

(Cont'd)

The FCC's rejoinder that several States had previously adopted "the forward-looking approach," and that concerns about workability thus "are largely refuted by practical experience," FCC Br. 47, is debunked above. *See supra* pp. 2-4 & n.2. None of the 14 States relied upon in the Order had implemented a pricing methodology based on the hypothetical replacement cost of the entire network.[16]

The FCC's concerns over the alleged "administrative difficulties" of an historical cost methodology, FCC Br. 48-49, are frivolous. First, the fact that an historical cost methodology requires some effort does not render a blank-slate methodology less speculative or more workable. Just last year, the FCC stated that historical cost pricing "brings certainty to the regulatory

(Cont'd)
output, and thus takes the existing configuration of assets as a given. For example, in determining the long-run incremental cost to CSX of 1 million passenger miles, one could measure the cost of new rolling stock, employees, advertising, *etc.*, *given* existing rail lines, the compatibility of new trains with old trains, and similar factors. *See generally* Alfred E. Kahn, *Whom the Gods Would Destroy, or How Not to Deregulate* 4 (2001). By contrast, a determination of the long-run cost of CSX's *entire rail system* is not an "incremental" inquiry at all — it seeks to measure the total costs that CSX would be expected to incur over the long run. Given the nature of a railroad network, a proper forward-looking analysis would assume a baseline configuration in year one comprised of the existing long-lived capital assets, and then project phased replacement over time. *See* ILEC Resp. Br. 17-22. The FCC's basic mistake – and what is inherently arbitrary about TELRIC — is that it conflates these two distinct approaches. TELRIC asserts that, because CSX will replace its entire system over 30+ years, an "incremental" methodology requires regulators to assume that CSX replaced the entire system *all at once on day one*.

[16] No State cited by the FCC as employing a forward-looking methodology, *see* J.A. 335 (¶ 631 nn.1509-10), had adopted a blank-slate approach, and a number expressly rejected it as inherently unworkable. *See, e.g.*, J.A. 100 (Conn. Comm'n Comments, Att. C at 9-10) (rejecting "scorched node" approach as a "somewhat existential methodology"); *see also In re a Methodology to Determine LRIC*, No. U-10620, 156 P.U.R.4th 1, at Ex. A (Mich. PSC Sept. 8, 1994) ("The least-cost technology is not the 'scorch the earth' approach where you begin from scratch or some hypothetical network that will never exist.").

process" and rejected a forward-looking measure because it would necessitate a "complicated pricing investigation." *Amendment of Rules and Policies Governing Pole Attachs.*, 15 F.C.C.R. 6453, ¶ 25 (2000). Second, the allocation of actual expenditures to the assets that those expenditures actually produced — a task regulators have performed for decades, *see Iowa Bd.*, 525 U.S. at 423 (Breyer, J., concurring in part and dissenting in part) — is infinitely swifter and more certain than virtual reconstruction of the entire network.

2. In TELRIC, the FCC sacrificed the goals of the Act to pursue its own regulatory vision of "efficient competition." The statute's objectives are to open the local market to the process of competition, to encourage investment by all competitors in advanced telecommunications facilities, and fully and fairly to compensate incumbents for the use of their facilities. *See* H.R. Conf. Rep. No. 104-458, at 1 (1996); H.R. Rep. No. 104-204, at 73; *see also Iowa Bd.*, 525 U.S. at 413-18 (Breyer, J., concurring in part and dissenting in part). The FCC contravened these goals by setting UNE prices to *prevent* facilities-based entry in circumstances the agency deemed "inefficient." FCC Br. 42. The FCC thus presumed to substitute its own central plan for the competitive process that the Act envisions. *See* ILEC Resp. Br. 24-25. None of the FCC's asserted justifications for this subversion of the Act's goals can withstand scrutiny.

First, the FCC claims that setting UNE prices at historical costs would send the "wrong" signal, thus prompting "inefficient" entry. FCC Br. 41-42. Yet competitors base their decisions not only on the UNE price, but also on the costs of other potential competitors and the prospect that the incumbent will drop its own prices below historical costs to avoid bypass. Even if the agency's concern about price signals were justified, it would not explain the FCC's refusal to allow historical cost recovery through other means — such as Ramsey pricing or a mechanism separate from UNE rates. *See Iowa Bd.*, 525 U.S. at 423 (Breyer, J., concurring in part and dissenting in part).

Second, the FCC arbitrarily assumed that TELRIC was a better gauge of real forward-looking costs than actual prudent investment. While historical costs have been subject to both prudency review and price caps, TELRIC is, by definition, unattainable. Given its assumption of a network with evergreen optimality, coupled with old-style depreciation and rates of return, no carrier can ever beat TELRIC prices with its own facilities. *See* ILEC Resp. Br. 25-33. Even if a firm could meet TELRIC costs, prices would not immediately drop to that level, as the U.S. Department of Commerce advised the FCC. J.A. 181-82 (NTIA Reply Comments at 23 n.43 ("Commerce Comments")). The FCC simply pronounced that the existing network "reflect[ed] inefficient or obsolete network design and technology," J.A. 383 (¶ 684), *because its costs were higher than the hypothetical TELRIC network.* That conclusion is entirely irrational — no real network can (or should) match TELRIC's ubiquitous optimality. *See* ILEC Resp. Br. 17-22. After five years, the FCC is still unable to specify what these alleged "inefficiencies" are, or how TELRIC may deny recovery based on hypothetical efficiency levels almost 10 times greater than the FCC has found achievable in its price cap orders.

Third, the FCC ignored the danger that setting UNE prices too low was greater than the risk of setting them too high. If prices based on historical costs are too high (*i.e.*, they reflect real "inefficiency"), the market will self-correct as incumbents drop wholesale prices to avoid facilities bypass. On the other hand, if TELRIC sets prices so low that potential facilities-based entrants would instead choose to ride on incumbents' UNEs, real efficiency gains will be lost. *See* J.A. 182 (Commerce Comments at 23) ("[I]f interconnectors receive rates associated with the least cost method of production, none will have the incentive to create its own efficient network."). TELRIC thus deters efficient entry, discourages investment by both incumbents and entrants, and prefers one form of entry (UNEs) over another (facilities).

CONCLUSION

The judgment below should be reversed in part.

Respectfully submitted,

MARK L. EVANS
MICHAEL K. KELLOGG
KELLOGG, HUBER, HANSEN,
TODD & EVANS, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for BellSouth Corporation, SBC Communications Inc., United States Telecom Association, and Verizon Entities

CHARLES R. MORGAN
JAMES G. HARRALSON
BELLSOUTH CORPORATION
1155 Peachtree Street, N.E.
Atlanta, GA 30309
(404) 249-2641

Counsel for BellSouth Corporation

WILLIAM P. BARR
M. EDWARD WHELAN
VERIZON
1850 M Street, N.W.
Washington, D.C. 20036
(202) 463-5200

PATRICK F. PHILBIN
Counsel of Record
JENNIFER R. BROSNAHAN
KIRKLAND & ELLIS
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 879-5000

MICHAEL E. GLOVER
VERIZON
1320 N. Courthouse Road
Arlington, VA 22201
(703) 974-2944

Counsel for Verizon Entities

ANDREW G. MCBRIDE
SCOTT DELACOURT
KRISTINA R. OSTERHAUS
WILEY REIN & FIELDING LLP
1776 K Street, N.W.
Washington, D.C. 20006
(202) 719-7000

HENRY WEISSMANN
MUNGER, TOLLES & OLSON LLP
355 S. Grand Avenue
Los Angeles, CA 90071
(213) 683-9100

Counsel for Verizon Entities

JAMES D. ELLIS
PAUL K. MANCINI
SBC COMMUNICATIONS INC.
175 E. Houston
San Antonio, TX 78205
(210) 351-3500

ROGER K. TOPPINS
GARY PHILLIPS
SBC COMMUNICATIONS INC.
1401 I Street, N.W.
Suite 1100
Washington, D.C. 20005
(202) 326-8891

Counsel for
SBC Communications Inc.

LAWRENCE E. SARJEANT
LINDA L. KENT
KEITH TOWNSEND
JOHN W. HUNTER
JULIE E. RONES
UNITED STATES TELECOM ASSOCIATION
1401 H Street, N.W.
Suite 600
Washington, D.C. 20005
(202) 326-7371

Counsel for United States
Telecom Association

July 23, 2001

FILED
JUL 23 2001
OFFICE OF THE CLERK

JUL 23 2001

Nos. 00-590, 00-511, 00-555, 00-587, 00-602

IN THE

Supreme Court of the United States

AT&T CORP.,

Petitioner,

v.

IOWA UTILITIES BOARD, *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF OF AT&T CORP.

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY AUSTIN BROWN & WOOD
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner

* Counsel of Record

July 23, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
INTRODUCTION AND SUMMARY OF ARGUMENT	1
ARGUMENT	
I. TELRIC IS AUTHORIZED BY THE STATUTE AND IS MANIFESTLY NOT ARBITRARY	2
II. THE NETWORK ELEMENT COMBINATIONS RULES ARE VALID	19
CONCLUSION	20

TABLE OF AUTHORITIES

CASES — Page

AT&T Corp. v. *Iowa Utils. Bd.*, 525 U.S. 366 (1999) 3, 19, 20
American Commerical Lines, Inc. v. *Louisville & Nashville R.R.*, 392 U.S. 571 (1968) 15
Bell Atlantic-Delaware, Inc. v. *McMahon*, 80 F. Supp. 2d 218 (D. Del. 2000) 14
In Re Permian Basin Area Rate Cases, 390 U.S. 747 (1968) 15
Southwestern Bell Tel. Co. v. *AT&T Communications of the Southwest, Inc.*, No. A 97-CA-132-55, 1998 WL 657717 (W.D. Tex. Aug. 31, 1998) 14
United States v. *Williams*, 504 U.S. 36 (1992) 19

REGULATIONS

47 C.F.R. § 51.315 ..... 19, 20
§ 51.505(b) 4, 10, 13

ADMINISTRATIVE DECISIONS

A Methodology To Determine Long Run Incremental Cost, 156 P.U.R.4th 1 (Mich. Pub. Serv. Comm'n 1994) 5
Approval of Agreements & Arbitration of Unresolved Issues, 180 P.U.R.4th 521 (Md. Pub. Serv. Comm'n 1997) 14
Bell Atlantic-Virginia, Inc., No. PUC970005, 1998 WL 352676 (Va. State Corp. Comm'n May 22, 1998) 14
Coal Rate Guidelines, 1 I.C.C.2d 520 (1985), *aff'd*, 812 F.2d 1444 (3d Cir. 1987) 7
Depreciation Requirements for Incumbent Local Exchange Carriers, 15 FCC Rcd. 242 (1999) 13
In Region InterLATA Servs. in Kan. & Okla., No. 00-217 (F.C.C. Jan. 22, 2001) 13

TABLE OF AUTHORITIES – continued

Page

Nextlink Pa., Inc., 196 P.U.R.4th 172 (Pa. Pub. Util. Comm'n 1999) 14
Petition for Arbitration, Nos. TO-97-40 & TO-97-67 (Mo. Pub. Serv. Comm'n July 31, 1997).. 13
Rates for Dominant Carriers, 2 FCC Rcd. 5208 (1987) 19

SCHOLARLY AUTHORITIES

W. Baumol, *Economic Theory and Operations Analysis* (4th ed. 1977) 5
W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose?*, 73 N.Y.U. L. Rev. 1122 (1998) 16
W. Baumol & J. Sidak, *Toward Competition In Local Telephony* (1994) 6, 18
S. Breyer, *Regulation and Its Reform* (1982) 6, 13
C. Horngren et al., *Cost Accounting: A Managerial Emphasis* (10th ed. 2000) 8
1 A. Kahn, *The Economics Of Regulation* (1988) 8, 10, 18
D. Watson & M. Holman, *Price Theory And Its Uses* (4th ed. 1977) 4

OTHER AUTHORITIES

Australian Competition & Consumer Comm'n, *Access Pricing Principles – Telecommunications* (1997) 5
Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market*, 1997 C(97)3148 ..... 5, 6, 7

TABLE OF AUTHORITIES – continued

Page

1 Financial Accounting Standards Bd., *FAS No. 89: Financial Reporting and Current Prices, in Original Pronouncements: Accounting Standards as of June 1999* (1999) 6

Infocomm Dev. Auth. of Singapore, *Appendix 1: Interconnection/Access In A Fully Liberalized And Developed Convergent Environment, in Second Consultation June-30th* (2000) 5

Oftel, *Access to Bandwidth: Indicative Prices and Pricing Principles* (2000) 7

INTRODUCTION AND SUMMARY OF ARGUMENT

1. The LECs' respondents' briefs have not defended the Eighth Circuit's judgment on TELRIC. The Eighth Circuit invalidated only the subsection of TELRIC that requires that rates be based on efficient replacement costs, and it upheld TELRIC's ban on "consider[ing]" the LECs' historical book costs. As is now undisputed, these holdings would require that network element rates be based on either (1) the universally discredited method of determining the costs of reproducing obsolete technology at today's prices or (2) a short run incremental cost method in which LECs recover their operating expenses but receive no recovery based on the value of their fixed capital investments.[1]

Because the LECs have no interest in defending either alternative permitted by the Eighth Circuit's judgment, they have devoted their "respondents' briefs" to rearguing the claims that were made or should have been made in their petitioners' brief. In particular, they here argue that the FCC was required to reject TELRIC and to adopt a method in which network element rates are based on the LEC's historical "sunk" costs, either in whole or in substantial part.

There is no merit to the claims that TELRIC violates the statutory requirement that network element rates be "based on the cost of providing the element." The Order's unchallenged findings and the uniform decisions of regulatory and accounting bodies all establish that TELRIC represents the "real," "economic," and "current" costs that the LECs incur in providing their existing network elements.

The LECs' arguments that TELRIC is arbitrary and capricious rest on a series of misstatements of the FCC's

---

[1] In their opposition to the petitions for certiorari (p. 11), BellSouth, SBC, and Verizon ("Bell") contended that the Eighth Circuit said no such things, but Bell's claim was refuted in AT&T's Petitioner's Brief (pp. 37-40), and Bell has now abandoned it.

Order. Their principal contention is that the FCC did not understand that LECs' investments are "sunk" once they are made and that the practice of "anticipatory retardation" means that LECs' networks inherently contain a mix of new, efficient and older, costlier technologies. However, the FCC's Order explicitly acknowledged these facts, and TELRIC requires states to establish the depreciation and rate-of-return components of the rates at levels that reflect the "sunk" character of LEC investments and all the risks of operating under TELRIC and the 1996 Act.

2. The Eighth Circuit's refusal to reinstate the FCC's network element combinations rule was erroneous. The rules reasonably prevent discrimination, and the Eighth Circuit's contrary holding rests on the same interpretation of § 251(c)(3) that this Court has expressly rejected.

I. TELRIC IS AUTHORIZED BY THE STATUTE AND IS MANIFESTLY NOT ARBITRARY.

As was explained in AT&T's prior briefs, TELRIC represents a manifestly permissible method of implementing the 1996 Act. This "bottom-up" method is the most direct, reliable, and administrable method both of identifying the real and economic costs that LECs incur to provide the network elements required to serve today's retail customers and of preventing LECs from illicitly foisting retail costs and costs of serving future customers on their retail competitors. At the same time, because the FCC's TELRIC regulations provide that the depreciation and rate-of-return components of the rates are to reflect all the risks of operating under this regime, the FCC's TELRIC regulations unequivocally permit states to set rates that reasonably and fully compensate the LECs.

By contrast, a "top-down" historical-cost method would begin with book costs that regulators have found to be unreliable and inflated and that bear no relationship to today's costs of meeting existing demand. It would further depend on a series of adjustments or arbitrary cost allocations to exclude

phantom or imprudent investments, to exclude retail costs, to exclude facilities built to serve future customers, and to determine costs in areas of different population densities. In practice, this method would almost assuredly produce rates that are wildly in excess of the costs that the LECs incur when they use their local loops and other bottleneck facilities to provide their own competing retail services. The result would be "discrimination" that violates § 252(d)(1)(A)(ii) and a "price squeeze" that would prevent retail competition from developing in the "*un*shared" parts of the network. Cf. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 429 (1999) (Breyer, J., concurring and dissenting in part).

That is why "total service" long run incremental cost methods like TELRIC have long been used by the FCC, other federal agencies, state commissions, and antitrust courts to determine the maximum prices that incumbent monopolists may charge their retail competitors for access to essential facilities. That is why the European Commission, its member states, and other foreign regulatory bodies have adopted the method. And that is why the state commissions who have been applying TELRIC for the past five years have defended TELRIC's validity in this Court. See NARUC Br. 12-14.

The LECs challenge TELRIC by making a series of claims that are pervaded with rhetoric, but that lack any substance.

1. First, the LECs incongruously rely on the "necessary or impair" standard of § 251(d)(2), which determines the network elements that LECs are required to make available. The LECs note that this Court held that the FCC misinterpreted these terms in their original 1996 Order; they contend that the FCC made the same error in the intervening decision on remand (which is now before the D.C. Circuit), and they suggest, on these bases, that the network elements that the FCC has designated are facilities that CLECs could readily duplicate. Bell Br. 2; Qwest Br. 26-27.

But TELRIC is the standard that applies to pricing the network elements that are properly designated under § 251(d)(2), and there is no dispute that the facilities that have been designated network elements are "generally . . . bottleneck[] monopol[ies]" under any standard. Order, ¶ 702 (JA 395). For example, in the pending D.C. Circuit appeal, the LECs have not challenged the FCC's requirement that they provide access to the ordinary copper local loops that AT&T now leases and combines with its own switching and other facilities to offer local service to business customers. AT&T Pet. Br. 14-15. This local-services competition is tenuous at best, and it would end if the rates for these bottleneck facilities exceeded the economic costs that LECs incur when they use the same facilities in their competing retail services.

2. AT&T has previously refuted the claims that the FCC violated the statutory requirement of § 252(d)(1)(A)(i) by requiring that network element rates be "based on the use of the most efficient telecommunications technology currently available." 47 C.F.R. § 51.505(b)(1). The LECs are simply wrong that § 252(d)(1)(A) requires that cost determinations be based on the specific costs of the LEC and its network. See AT&T Pet. Br. 36-37. Further, even if the Act imposed this requirement, TELRIC measures the "actual costs" that each LEC incurs in providing its existing facilities. *Id.* at 28-34.

Long run incremental cost is a well-accepted method of determining the costs of individual firms. Yet all long run incremental cost methods can be characterized as making determinations based on a "hypothetical carrier" and an "ideally efficient" network that does not exist. Compare Bell Br. 16; Qwest Br. 2-3. Long run incremental cost methods inherently assume "a wholly new . . . plant." D. Watson & M. Holman, *Price Theory And Its Uses* 195 (4th ed. 1977). As the European Commission explained, the long run "is the time horizon in which the firm could adjust (downwards or

upwards) all of its inputs, including the size of each and any of its production plant, to meet a decrement or increment in the volume of production." Commission of the European Communities, *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market* § 3.3, 1997 C(97)3148 ("*European Commission Report*"). *Accord* Order, ¶ 677 & n.1682 (JA 378) (citing W. Baumol, *Economic Theory and Operations Analysis* 290 (4th ed. 1977)). Any long run incremental cost method further assumes that a firm will select "that plant which produces its output at the lowest possible cost." Baumol, *supra*, at 291. Thus, when state commissions and the FCC used long run incremental cost methods to set maximum prices for access to essential LEC facilities before the 1996 Act was passed, they made their determinations based on "the least-cost, most efficient technology that is currently available for purchase."[2] Foreign regulators apply this same standard.[3]

Contrary to Bell's claims, the "current cost" of using the entity's existing plant and equipment is a function of its efficient replacement cost, not the price that was paid for the equipment up to "30 years" ago. Compare Bell Br. 5. The past expenditures are "sunk," "unavoidable" and irrelevant to the cost of using equipment today. The cost of using equipment today is a function of the facts that today's use causes it to wear out faster and to have to be replaced sooner. Replacement cost measures the value of the equipment, and replacement cost therefore is the basis for measuring the

---

[2] *A Methodology To Determine Long Run Incremental Cost*, 156 P.U.R.4th 1, Ex. A at 13 (Mich. Pub. Serv. Comm'n 1994); *see* AT&T Pet. Br. 11-12.

[3] AT&T Pet. Br. 21; *see also* Australian Competition & Consumer Comm'n, *Access Pricing Principles – Telecommunications* 23 (1997) ("the most efficient technology that is commercially available"); Infocomm Dev. Auth. of Singapore, *Appendix 1: Interconnection/Access In A Fully Liberalized And Developed Convergent Environment, in Second Consultation June-30th*, ¶¶ 5.1.1, 5.1.2.3 (2000).

"real" and "economic" cost of the use of the equipment. See AT&T Pet. Br. 19-21 & 30-31; S. Breyer, *Regulation and Its Reform* 38 (1982).

As the European Commission has stated, once an investment is made, the firm "can either sell the asset to the highest bidder or it can use the asset to produce a good or service which the firm sells to generate an income." *European Commission Report* § 3.3. The cost of using the asset is the opportunity cost of using it rather than selling it at its value. It is determined by the prices of the most efficient substitutes that are commercially available.[4] W. Baumol & J. Sidak, *Toward Competition In Local Telephony* 60 (1994). Thus, in addition to the decisions of the European Commission and other regulatory bodies cited in AT&T's Petitioner's brief (19-21), accounting standards provide that "[t]he current cost of property, plant, and equipment owned by an enterprise is the current cost of acquiring the same service potential ... as embodied by the asset owned," not what was paid for it years ago. 1 Financial Accounting Standards Bd., *FAS No. 89: Financial Reporting and Current Prices, in Original Pronouncements: Accounting Standards as of June 1999*, at 919, ¶ 18 (1999).

The LECs also attempt to dispute that the decisions of other bodies confirm that TELRIC represents the economic costs that monopolies incur in providing essential facilities. Qwest asserts that the prior antitrust, FCC and state decisions cited in AT&T's Petitioner's Brief only set a "price *floor*" of short run or long run incremental cost for a monopolists' retail services. Qwest Br. 36. That is false. The decisions also set a price ceiling for the essential inputs that are provided to competitors of total service long run incremental cost plus a

---

[4] Bell's claim (Br. 19) that there is no "market" for telephone networks is irrelevant and erroneous. There is a market to supply the facilities used in providing network services, and it is the prices of the most efficient technologies currently available that determine replacement costs.

markup for joint and common costs: *i.e.*, TELRIC. AT&T Pet. Br. 11-12.

Similarly, both the European Commission and Oftel (the FCC's British counterpart) expressly adopted the same total service long run incremental cost standard to govern the pricing of network elements provided by their incumbent LECs.[5] In suggesting otherwise, Bell (Br. 35) relies on the irrelevancy that the European Commission and Oftel authorized the use of alternative measures during the interim period before long run incremental cost studies could be developed and refined. The FCC's Order did the same thing. Order, ¶¶ 787-827 (JA 894-914).

There also is no substance to Bell's claim (Br. 34-35) that there are critical differences between TELRIC and the efficient replacement cost methodology that the ICC has used to set maximum railroad rates for captive shippers. Contrary to Bell's mistatement (*id.* at 34), the ICC method does not assume a railroad built to serve only "one shipper" or group of shippers "on a particular route" and thus does not deny shippers the economies existing between that route and the rest of the railroad. To the contrary, like TELRIC, the ICC's method was developed for the express purpose of "taking advantage of economies of density" and allows rates to be set based on the replacement cost of the entire railroad or any hypothetical routes that enjoy economies of scale, scope or density. *Coal Rate Guidelines*, 1 I.C.C.2d 520, 542-43 & 547 n.75 (1985), *aff'd*, 812 F.2d 1444 (3d Cir. 1987).

---

[5] *European Commission Report*, §§ 3.3, 3.5; Oftel, *Access to Bandwidth: Indicative Prices and Pricing Principles*, ¶¶ 3, 9 (2000). Bell's Brief misrepresents Oftel's more recent order. Because LRIC cost models had not been finalized for a single element (the local loops), Oftel there decided to set interim rates by using the results of the incumbent's "'top down'" cost model as a "starting point," and using the results from the most recent proposed long run incremental cost model "to ensure that only relevant costs are included within the calculation." *Id.*

3. The LECs' remaining arguments are that the adoption of TELRIC was arbitrary and capricious. Their basic contention is that the FCC's TELRIC method is suitable only for markets like "pork bellies" and other commodities. Bell Br. 28. They contend that the method is wholly inappropriate in capital-intensive businesses like telecommunications in which equipment has useful lives of up to 30 years, in which facility investments are thus "sunk" once they are made, and in which technology costs are rapidly declining (at least in some segments). They assert that the FCC overlooked these obvious facts about the industry in concluding that TELRIC reasonably "mimics" the prices that would prevail in competitive markets. These claims are refuted by the face of the FCC's Order.

a. The LECs' primary claim is that the FCC's Order rests on the false premise that LECs' networks should always be comprised exclusively of the most efficient technology and that the LECs should adopt the "suicidal business plan" of constantly "tearing down its existing network and building a new one from scratch." Bell Br. 17-18, 21, 25-27; see Qwest Br. 13, 29-31. As the LECs correctly state, no carrier rationally would or should replace functional "sunk" equipment merely because more efficient technology becomes available. Rather, carriers practice "'anticipatory retardation'" in which they delay investment in new and more efficient technology until such time as the relative advantages that the new equipment offers are sufficiently great that it is clear that the carrier can earn the anticipated return and depreciation over the life of the new plant. 1 A. Kahn, *The Economics of Regulation* 119 n.91 (1988).

The LECs' claim is a strawman. Making efficient investment decisions and the costing and valuation of assets are entirely separate matters. See C. Horngren, *Cost Accounting: A Managerial Emphasis*, 378-79, 396-400 (10th ed. 2000); 1 A. Kahn, *The Economics Of Regulation*, 118-19

(1988). TELRIC, in turn, is not a prescription of criteria to govern the LECs' investment decisions. It is a method of valuing the investments that the LECs have made for purposes of setting rates. In turn, TELRIC's valuation of the LECs' facilities is one of inputs that is used to determine two of the components of the LECs' "economic" costs of providing network elements: the annual depreciation allowance and the return on the LECs' investment.

In adopting TELRIC, the FCC acknowledged the very characteristics of telecommunications and other capital-intensive industries that the LECs accuse the FCC of ignoring. The FCC expressly noted that local exchanges are capital-intensive businesses characterized by "significant sunk investment [and] declining technology costs." Order, ¶ 686 (JA 384). In this regard, the FCC was relying on the testimony of Professor Baumol and the others who had acknowledged "these principles" and demonstrated that TSLRIC represents the stream of revenues that provide full compensation to firms in capital-intensive industries, be they competitive industries like semiconductors or monopolies like local telephone networks. Compare AT&T Reply Comments (May 30, 1996), W. Baumol et al. Reply Aff. at 2 (JA 141-42), with Bell Br. 29-30 n.28. The FCC found that the depreciation and cost of capital components of TELRIC fully account all the risks and costs that LECs "incur" due to the combination of significant "sunk investments, declining technology costs, and competitive entry." Order, ¶ 686 (JA 384); see also *id.* ¶¶ 687-689 & 702-703 (JA 385-86 & 395-96). In short, the FCC expressly considered and specifically rejected, the LECs' claims, holding that, "even in the presence of [the LECs'] sunk costs, TELRIC-based prices are an appropriate pricing methodology." *Id.* ¶ 703 (JA 396).

Indeed, although the LECs' briefs are filled with selective quotations of statements by their economic experts, these economists admitted in their testimony before the FCC that

TELRIC will result in fully appropriate network element prices if depreciation and cost of capital calculations reflect all the risks of operating under this regime. See AT&T Pet. Br. 16-17 (citing testimony of Kahn, Tardiff & Hausman); *accord* 1 A. Kahn, *The Economics of Regulation*, 121-22 (1988). The LECs ultimately concede this point. Bell Br. 29. However, the LECs contend that the FCC rules for calculating the depreciation and rate of return components of network element rates are inadequate and are incapable of being implemented by state commissions in a manner that reasonably compensates LECs for the economic costs of providing network elements. These claims, too, rest on misstatements of the FCC's Order.

b. Depreciation determines the percentage of the value of an asset that a LEC is allowed to recover in its rates in any one year. The depreciation component of a network element rate is a product both of the valuation of the asset (here replacement cost) and the state-determined rate of depreciation during the period in which the network element rate remains in effect. For example, if an asset is valued at $100 and the depreciation rate is 20%, the annual depreciation that will be included in the rate is $20. Obviously, a higher depreciation rate can entirely offset the consequences of a lower valuation of a network facility. Thus, even if it were the case that replacement costs for all network elements were constantly declining – as it is not – the LECs are simply wrong in asserting that states cannot establish depreciation allowances that provide LECs with adequate depreciation and capital recovery under TELRIC. See Bell Br. 4.

The LECs' contrary arguments appear to rest on the false premise that TELRIC requires states to set depreciation rates that reflect only the wear and tear on the asset which limits its physical useful life but that ignore the reductions in the value due to declining technology costs. That is incorrect. TELRIC requires that states use "economic depreciation rates" in setting network element rates. 47 C.F.R. § 51.505(b)(3). The

FCC made it explicit that the depreciation components of the rates must reflect not just wear and tear and the asset's physical life, but also "the true changes in economic value of an asset" (Order, ¶ 703 (JA 396)) and the "expected declines in the value of capital goods." *Id.* ¶ 686 (JA 384).

Thus, the FCC's regulations permit (and require) states to establish depreciation rates that compensate LECs for the expected loss in economic value of their network elements. For example, if a switch that cost $100 today had a useful physical life of 10 years and if the replacement cost is declining by 10% a year, it would violate TELRIC if states set depreciation at 10% of the replacement cost each year over ten years. Cf. Bell Br. 4. That would result in depreciation that totalled $65.10 over the life of the switch (*i.e.* $10 in depreciation the first year, $9 the second, $8.10 the third, etc.). TELRIC would here require the state to select an accelerated or other method in which the switch were depreciated over a period of less than ten years.[6] The LECs can then receive annual depreciation allowances that total $100 over the economic life of the switch.

Bell (*id.* at 33 n.25) and Qwest (Br. 35-36) erroneously assert that the Act or the FCC's rules requires states to recalculate TELRIC rates continuously or annually. Indeed, the almost uniform state practice (which the LECs defend) is to establish rates that remain in effect for a period of three years or longer. However, if appropriate depreciation calculations are made under TELRIC, LECs will be protected

---

[6] For example, an accelerated depreciation method might provide for depreciation of $20 the first year, $19 the second, $18.10 the third, *etc.* – and total $100 over a period of approximately 5.5 years. Alternatively, a straight-line method might allow depreciation of $14.30 per year over a period of about seven years, again totaling $100.

against expected declines in the loss of value of their assets under any scenario.[7]

The LECs misstate the FCC's Order in other ways. They claim that FCC has required states to set network element rates based on the depreciation rates that the FCC uses in regulating LECs' interstate exchange access services – unless the LECs prove that they currently face facilities-based competition in the provision of network elements. Bell Br. 32-33. This is simply false. The FCC's rules unconditionally require the use of economic depreciation that takes into account expected changes in technology costs, irrespective of whether there are any alternatives to the LEC's network elements. The FCC's Order states (¶¶ 687-688, 702-703 (JA 385-86, 395-96)) that the likelihood that alternatives will be developed to LEC network elements is a consideration in making the separate rate of return and cost of capital determinations (where that fact is relevant), *not* in the calculation of depreciation rates (where it is irrelevant).

Further, to the extent that the Order requires states to use the FCC's prescribed depreciation rates if no other alternatives are presented, the FCC plainly acted entirely reasonably. Contrary to the LEC's suggestion, the FCC depreciation rates have been set to reflect the expected declines in asset values, and the FCC has found that these rates reflect all the risks that LECs face and that LECs have substantial depreciation reserve surpluses. AT&T's Resp. Br.

---

[7] Bell now contends (Br. 4 n.4) that it would incur losses if there were an "unexpected[]" 20% drop in the replacement cost of a plant (from $100 to $80) after a state set network-element rates in year one and before it recalculated those rates in year two. This argument rests on the implausible assumption that states would not adjust the depreciation rate in the second year, and would readopt the same annual depreciation rate (10%) – such that the allowed depreciation would drop from $10 to $8. Further, even if LECs were to end up bearing the risk of unexpected declines in asset values, they also reap the benefits of unexpected developments that enhance asset values.

27. More fundamentally, the FCC's prescriptions are merely a default rule. The Order (¶ 686 (JA 384-85)) expressly allows parties to "propose" and the states to adopt "specific depreciation rate adjustments that reflect expected asset values over time," and on occasion states have set network element rates based on depreciation lives that are as much as 50% shorter than those assumed by the FCC.[8] Contrary to the LECs' misstatement (Bell Br. 32 n.24), the FCC has upheld the lawfulness of such state measures.[9]

TELRIC's depreciation rules thus reasonably protect LECs against the risks that result from using current replacement costs to value LECs' sunk investments in network element. These risks exist whether or not LECs continue to have monopolies over network elements, and the depreciation rules allows states to provide LECs a return *of* their investments.

c. The cost of capital/rate of return components of rates are designed to provide LECs with a return *on* their investment that is sufficient to reflect all the risks that LECs face in their businesses and to assure that they can continue to attract private capital. See S. Breyer, *Regulation and Its Reform* 40-47 (1982). The FCC fully addressed this interest of LECs. It required that states set TELRIC rates that include "the forward-looking cost of capital." 47 C.F.R. § 51.505(b)(2). The Order acknowledged that "the combination of significant sunk investment, declining technology costs, and competitive

---

[8] *Compare, e.g., Petition for Arbitration*, Nos. TO-97-40 & TO-97-67, slip op. at 110-14 (Mo. Pub. Serv. Comm'n July 31, 1997) (adopting for example a 13.7 year depreciation life for aerial fiber cable), *with Depreciation Requirements for Incumbent Local Exchange Carriers*, 15 FCC Rcd. 242, app. B (1999) (adopting a prescribed depreciation range for aerial fiber cable of 25 to 30 years).

[9] *See, e.g., In-Region InterLATA Servs. in Kan. & Okla.*, No. 00-217, slip op. ¶ 76 (F.C.C. Jan. 22, 2001) (upholding depreciation lives even though they were lower than the FCC's prescribed depreciation lives and pointing out that the FCC has "never stated that states should be precluded from setting depreciation rates that differ from the Commission's").

entry may increase the . . . cost of capital of incumbent LECs" (Order, ¶ 686 (JA 384)), and it required that states set network element rates that include a "cost of capital that appropriately reflects the risks incurred by an investor." *Id.* ¶ 703 (JA 396). There is no merit to any of the LECs' objections to this aspect of the Order.

First, they complain that the FCC mandated that states use the federally prescribed rate of return of 11.25% if the parties to the state proceeding do not propose a higher or lower rate of return. Bell Br. 31-32. But again, this is just a default rule. Moreover, the 11.25% was established in 1990 when interest rates were much higher than today, and states and federal courts that have addressed the LECs' cost of capital in providing network elements have generally determined that 11.25% is too high under current conditions.[10]

Next, Bell claims (*id.* at 30) that the FCC erred by refusing to prescribe a rate of return of 22%-33% and by instead leaving rate of return calculations to state commissions. It notes that LECs presented "evidence" (an affidavit of Dr. Jerry Hausman) that the LECs' cost of capital under TELRIC and the 1996 Act will be "at least two to three times higher than the rate of return authorized in the old monopoly environment," and contends that it was arbitrary for the FCC to refuse to impose Hausman's view on the states.

This claim is baseless. AT&T and MCI each submitted detailed expert affidavits that demonstrated that Hausman's

[10] *See, e.g., Bell Atlantic-Virginia, Inc.*, No. PUC970005, 1998 WL 352676, at *3, *8 (Va. State Corp. Comm'n May 22, 1998) (10.12 percent); *Approval of Agreements & Arbitration of Unresolved Issues*, 180 P.U.R.4th 521, 531 (Md. Pub. Serv. Comm'n 1997) (10.1 percent); *Nextlink Pa., Inc.*, 196 P.U.R.4th 172, 210 (Pa. Pub. Util. Comm'n 1999) (9.83%); *Bell Atlantic-Delaware, Inc.* v. *McMahon*, 80 F. Supp. 2d 218, 239-41 (D. Del. 2000) (upholding rate of 10.28%); *Southwestern Bell Tel. Co.* v. *AT&T Communications of the Southwest, Inc.*, No. A 97-C-132-55, 1998 WL 657717, at *13 (W.D. Tex. Aug. 31, 1998) (upholding rate of 10.36 %).

affidavit should be given no weight. They showed that it was based on a misunderstanding of standard cost of capital models, that it made such errors as confusing nominal and real interest rates, and that it rested on unfounded assumptions about the rate of construction of alternative facilities (that have been disproven by the intervening events over the past five years). JA 215-63. Further, based on this testimony, the FCC explained in some detail why it was "not persuaded" by the LECs' "evidence." Order, ¶¶ 686-689 (JA 384-86).

As this Court has held, it does not sit to umpire disputes among economists over ratemaking methodologies.[11] It would be peculiarly inappropriate to do so here, for the FCC's conclusions were well-founded. Beyond that, the FCC has not foreclosed the LECs from making these same claims to state commissions. It merely refused to rely on them to prescribe a rate of return that binds states. *Id.* ¶ 702 (JA 395-96).

The LECs next claim that the FCC arbitrarily prohibited states from deviating from the default (11.25%) cost of capital until "actual competition had in fact materialized." Bell Br. 32. That, too, is wrong. The FCC simply refused to require states to accept the LECs' unsupported assumption of massive and instantaneous entry that strands LEC investment, for the FCC concluded (correctly) that "[t]he more reasonable assumption" is one "of entry occurring over time" that will have little effect on LECs. Order, ¶ 688 (JA 386). Again, moreover, the FCC's Order did not bar LECs from making their contrary claims in the state proceedings.

The LECs also misstates the Order in contending that it prohibits states from adopting network element rates that would protect LECs against "emerging competition [that] threatens to strand investment" by allowing them to

[11] *American Commercial Lines, Inc.* v. *Louisville & Nashville R.R.*, 392 U.S. 571, 590 (1968); *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 791-92 (1968).

"*frontload* their recovery of costs." Bell Br. 31-33. As noted, the FCC did not bar states from adopting accelerated depreciation, which would result in rates that are dramatically higher in the early years of an investment. See *supra*.[12]

For these and other reasons, it is spurious for LECs to argue that TELRIC destroys the incentives of competitive local exchange carriers ("CLECs") to invest in facilities. Qwest Br. 21; Bell Br. 24, 29. The risk that CLECs will do so is reflected in the TELRIC-based rates that they must pay for network elements. Further, to foreclose any claim that TELRIC "may discourage facilities-based competition," the FCC required that TELRIC calculations be based not on the most efficient network design, but on LECs' existing wire centers. Order, ¶¶ 683, 685 (JA 382-84). Moreover, because of the enormous transaction costs that CLECs incur in using network service elements, they will have incentives to invest in alternative facilities whenever that is remotely feasible. These points are all confirmed by AT&T's massive investments to construct facilities that it could obtain as network elements.

d. The LECs also argue that the FCC's Order rests on the premise that prices will "instantly" drop because of the "mere availability of a new technology, whether in a lab or in the channels of commerce." Qwest Br. 30. In this regard, they rely on the fact that Professor Baumol has since stated that *if* TELRIC so assumed, "minor readjustment[s]" may be required. W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose?*, 73 N.Y.U. L. Rev. 1122, 1147 (1998). But the FCC's Order makes no such assumption. TELRIC requires that rates be based on the most efficient technology proven to be "operationally feasible and currently available." Order, ¶ 683 (JA 383). Further, there is

[12] The LECs also erroneously argue that the FCC unlawfully refused to allow them to charge "above-cost" rates to foster "innovation." Qwest Br. 35. Section 252(d)(1)(A) squarely prohibits above-cost rates.

nothing "instantaneous" about the implementation of TELRIC. Because of the period of time required to collect data, to prepare and decide a rate case, and to implement the resulting interconnection agreement, a period of several years generally passes between the commercial installation of efficient new technology in LEC networks and the availability of network elements at the rates that reflect the existence of the technology.

4. Against this background, there is no basis for the LECs' assertions that the FCC here attempted to divine the prices that would prevail if telecommunications service were a perfectly competitive market and to "short circuit" the competitive process by imposing these rates by "regulatory *diktat*." Bell Br. 24; Qwest Br. 21, 22. The FCC was addressing rates for facilities found to have substantial "bottleneck" characteristics in today's telecommunications market. These rates are based on "actual prices" that prevail in today's *monopoly* market when LECs install new network elements or replace existing ones using efficient technology (*i.e.*, the best practices of today's monopolists). The rates are to further rest on depreciation and rate-of-return calculations that reflect the LECs' risks in operating under TELRIC in today's conditions. The FCC did not (and could not) even attempt to divine what the prices would be in a market in which multiple firms could economically provide loops, switches and other network elements and in which their innovation in developing, providing, and provisioning the underlying equipment would surely lead to dramatic reductions in their costs and dramatic improvements in their efficiency and capabilities.

By making bottleneck facilities available at the "economic costs" that LECs in fact now incur in providing network elements in today's monopoly market, the 1996 Act and the FCC's Order merely created the possibility of innovation and competition in providing those elements of retail telephone services that do not have natural monopoly characteristics and

that Justice Breyer referred to as the "unshared" segments of telecommunications. Allowing *this* competition institutes a process that will drive retail prices closer to cost. In this regard, it is ironic that Qwest (Br. 21 n.11) relies on the FCC's decision not to prescribe cost-based exchange access charges. There, the FCC expressly relied on the fact that competitors who rely on network elements leased at TELRIC-based rates will drive access charges closer to competitive levels. The LECs' citations thus refute their accusations.

5. Finally, the alternatives to TELRIC that the LECs identify are all historical-cost methods that the FCC properly rejected for the reasons stated in the respondents' briefs of AT&T, the FCC, NARUC and WorldCom. First, that is the case with Qwest's purported "actual forward-looking costs." Qwest would set rates based on the sum of (1) the LECs' incremental costs over an "intermediate horizon," and (2) a return of and on its "fixed" investments in "any existing facilities that would remain in place during that time period." Qwest Br. 39. But as the FCC correctly held (Order, ¶ 686 (JA 384-85)), this is an improper historical-cost method. It allows recovery for "fixed costs on the old equipment – the depreciation that may not yet have been fully recovered, the return on the net investment not fully written off, interest on the debt already incurred." 1 A. Kahn, *The Economics of Regulation* 118 (1988).

For this reason, the FCC also properly rejected the so-called efficient component pricing method. Under it, rates for network elements would be set by taking the LECs' existing retail revenues and subtracting the LECs' incremental costs of supplying the retail and other inputs that its competitors will supply. But this method can result in efficient-component prices only if the retail revenues are capped by TSLRIC and are cost-based. W. Baumol & J. Sidak, *Toward Competition In Local Telephony* 108 (1994). As the FCC found, the LECs' "existing retail rates . . . are not cost based" and this method is thus "improper." Order, ¶¶ 708-711 (JA 401-03).

Qwest also mentions a "price cap" method – which no party advocated below. It would use historical costs to set initial network element rates and make annual adjustments to reflect increases in productivity. The FCC has also found that such methods do not result in cost-based rates. *Rates for Dominant Carriers*, 2 FCC Rcd. 5208, 5211-12 (¶ 22) (1987). Thus, price caps would violate the statute.

II. THE NETWORK ELEMENT COMBINATIONS RULES ARE VALID.

As AT&T's Petitioner' Brief demonstrated (40-46), the Eighth Circuit's refusal to reinstate Rules 315(c)-(f) rests on its conclusion that the "plain language" of the second sentence of Section 251(c)(3) prohibits the FCC from requiring combination of elements. This holding cannot be reconciled with this Court's holdings that (1) the second sentence is "ambiguous" and "does not say, or even remotely imply, that elements *must* be provided only in [discrete pieces] and never in combined form," and (2) "rational" network element combination rules that implement the "nondiscrimination requirement" imposed by Section 251(c)(3)'s first sentence are therefore lawful. *Iowa Utils. Bd.*, 525 U.S. at 394-95 (emphasis in original).

The LECs' arguments here are likewise at war with these holdings.[13] For example, the LECs' contention that Section 251(c)(3)'s second sentence "cannot [be] read . . . as *authorizing*" Rules 315(c)-(f) (Bell Br. 48 (emphasis in original)), attacks a strawman. As the Court found when it upheld Rule 315(b), these rules are authorized by the first sentence of Section 251(c)(3), not the second. The second

---

[13] The LECs reiterate, virtually verbatim, the contention they made in opposing certiorari that this issue has been "abandoned." Bell Br. 41-43. That contention was "necessarily considered and rejected" when certiorari was granted, *United States* v. *Williams*, 504 U.S. 36, 40 (1992), and is no longer properly before the Court. It is also meritless for the reasons stated in AT&T's Reply Brief in support of its petition for certiorari (pp. 8-9).

sentence is relevant only because the Eighth Circuit erroneously construed that sentence to *prohibit* FCC combination rules notwithstanding their nondiscrimination rationale.

The LECs argue (*id.* at 46) that Rules 315(c)-(f) cannot be supported by the nondiscrimination requirement because the FCC did not formally "cite" that requirement in the subsection of the Order adopting those rules. But that was the same subsection that adopted Rule 315(b), and this Court had no difficulty recognizing and upholding the nondiscrimination basis for that rule. *Iowa Utils. Bd.*, 525 U.S. at 395.

Finally, the LECs contend that no nondiscrimination concern is implicated here because the absence of Rules 315(c)-(f) would simply leave all carriers on an "equal footing." Bell Br. 45. That unsupported assertion simply ignores the FCC's well-supported finding (Order, ¶ 293 (JA 296)) that it would "in practice" be "impossible for new entrants that lack facilities and information about the incumbent's network" to combine the incumbents' elements themselves, and that absent these rules competitors would be "seriously and unfairly inhibited" in their ability to use network elements.

CONCLUSION

For the reasons stated, the Eighth Circuit's decision should be reversed insofar as it vacated Rules 51.315(c)-(f) and 51.505(b)(1).

Respectfully submitted,

MARK C. ROSENBLUM
LAWRENCE J. LAFARO
RICHARD H. RUBIN
AT&T CORP.
295 North Maple Avenue
Basking Ridge, NJ 07920
(908) 221-8410

DAVID W. CARPENTER*
PETER D. KEISLER
DAVID L. LAWSON
STEPHEN B. KINNAIRD
C. FREDERICK BECKNER III
SIDLEY AUSTIN BROWN & WOOD
1722 Eye St., N.W.
Washington, D.C. 20006
(202) 736-8000

Counsel for Petitioner

July 23, 2001

* Counsel of Record

Nos. 00-511, 00-555, 00-587, 00-590, 00-602

Supreme Court, U.S.
FILED
JUL 23 2001
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., *et al.*,
Petitioners,
v.
FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Respondents.

WORLDCOM, INC., *et al.*,
Petitioners,
v.
VERIZON COMMUNICATIONS, INC., *et al.*,
Respondents.

FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA,
Petitioners,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

AT&T CORP.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

GENERAL COMMUNICATION, INC.,
Petitioner,
v.
IOWA UTILITIES BOARD, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF ON THE MERITS OF SPRINT CORPORATION IN SUPPORT OF PETITIONERS FEDERAL COMMUNICATIONS COMMISSION AND UNITED STATES OF AMERICA

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000
Counsel for Respondent Sprint Corporation

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
PRELIMINARY STATEMENT	1
ARGUMENT	1
I. THE FCC's SELECTION OF A PRICING METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST DOES NOT VIOLATE THE ACT	1
A. The Telecommunications Act Of 1996 Does Not Mandate Recovery Of Historical Costs	1
B. The FCC's Selection Of A Cost Methodology Based On The Most Efficient Replacement Technology Was Reasonable And Rule 505(b)(1) Should Be Reinstated...	5
1. Rule 505(b)(1) Simulates The Real World Costs To A New Entrant In A Competitive Environment	5
2. Rule 505(b)(1) Encourages Facilities-Based Competition	8
3. The FCC's Cost Methodology Fairly Compensates ILECs For The Costs Of Providing UNEs	9
C. Rule 505(b)(1) Does Not Raise "Serious Constitutional Questions" Of A Takings Violation	11
II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS DOES NOT VIOLATE SECTION 251(c)(3) OF THE ACT	12

TABLE OF CONTENTS—Continued

	Page
A. Section 251(c)(3) Is Ambiguous	12
B. The UNE Combinations Rule Is Reasonable And Necessary To Ensure Meaningful UNE Access	15
C. Review Of The Combinations Rule Was Not Waived	18
CONCLUSION	20

TABLE OF AUTHORITIES

CASES

	Page
AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366 (1999)	*passim*
American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry., 387 U.S. 397 (1967)	12
Capital Network Sys., Inc. v. FCC, 28 F.3d 201 (D.C. Cir. 1994)	3
Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984)	6
Communist Party of the United States v. Subversive Activities Control Bd., 367 U.S. 1 (1961)	19
FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944)	3
GTE Serv. Corp. v. FCC, 205 F.3d 416 (D.C. Cir. 2000)	18
Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999)	14
Iowa Utils. Bd. v. FCC, Nos. 96-3321 *et al.*, Order (8th Cir. June 10, 1999)	19
Iowa Utils. Bd. v. FCC, 219 F.3d 744 (8th Cir. 2000)	2, 3, 19
New York Cent. R.R. v. White, 243 U.S. 188 (1917)	12
Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc., No. 97-D-CA-132, 1998 U.S. Dist. LEXIS 15,637 (W.D. Tex. Aug. 31, 1998)	7
Tennessee Elec. Power Co. v. Tennessee Valley Auth., 306 U.S. 118 (1939)	12
U S W. Communications, Inc. v. Jennings, 46 F. Supp. 2d 1004 (D. Ariz. 1999)	7

TABLE OF AUTHORITIES—Continued

	Page
Verizon Communications, Inc. v. FCC, 121 S. Ct. 877 (2001)	19
STATUTES	
47 U.S.C. § 251(c)(2)(C)	14
47 U.S.C. § 251(c)(3)	*passim*
47 U.S.C. § 251(c)(6)	18
47 U.S.C. § 251(d)(2)	16, 18
47 U.S.C. § 252(d)(1)(B)	*passim*
47 U.S.C. § 252(d)(2)	*passim*
AGENCY DECISIONS	
Implementation of the Local Competition Provisions in the Telecomms. Act of 1996, 11 F.C.C.R. 15,499 (1996)	*passim*
Implementation of the Local Competition Provisions of the Telecomms. Act of 1996, 15 F.C.C.R. 3696 (1999)	14
RULES	
Sup. Ct. R. 19.4	19
47 C.F.R. § 51.315(b) (2001)	*passim*
47 C.F.R. § 51.315(c)-(f) (2001)	*passim*
47 C.F.R. § 51.319 (2001)	17
47 C.F.R. § 51.505(b)(1) (2001)	*passim*
CONGRESSIONAL MATERIAL	
S. Rep. No. 104-23 (1995)	4
OTHER AUTHORITY	
Michael K. Kellogg *et al.*, *Federal Telecommunications Law* (1st ed. 1992)	6

PRELIMINARY STATEMENT

Pursuant to Supreme Court Rules 24.4 and 25.3, Respondent Sprint Corporation ("Sprint") respectfully submits this Reply Brief on the Merits of Sprint Corporation in Support of Petitioners Federal Communications Commission ("FCC") and the United States of America.[1]

ARGUMENT

I. THE FCC's SELECTION OF A PRICING METHODOLOGY BASED ON THE MOST EFFICIENT REPLACEMENT COST DOES NOT VIOLATE THE ACT.

A. The Telecommunications Act Of 1996 Does Not Mandate Recovery Of Historical Costs.

The ILECs generally repeat the same arguments made in their petitioners' brief in challenging the FCC's "most efficient replacement cost" methodology ("Rule 505(b)(1)") for pricing network elements ("UNEs") under the Telecommunications Act of 1996 ("Act"). The ILECs claim that the Act's wholesale pricing provision and the term "reasonable profit" in Section 252(d)(1)(B) demonstrate that historical costs are required; accordingly, they argue, the FCC's forward-looking "most efficient replacement cost" methodology is unlawful because it does not provide for their historical costs. BellSouth Br. at 15; Qwest Br. at 16-17.

The Act's wholesale pricing provision does not implicitly or explicitly endorse either a historical or forward-looking cost model. *See* Sprint Resp't Br. at 24. The wholesale price

---

[1] Separate opposition briefs were filed by a group of incumbent local exchange carriers ("ILECs") (*see* Brief for Respondents BellSouth, SBC, Verizon, and USTA) ("BellSouth Br.") and (*see* Brief for Respondent Qwest Communications International, Inc.) ("Qwest") ("Qwest Br."). Except where noted, this reply brief addresses the arguments raised in both briefs.

is based on the ILEC's retail tariff—which state commissions could determine based on a forward-looking cost methodology or using the ILEC's historical costs. *Id.* The wholesale pricing provision is thus neutral on the issue. Nor does Section 252(d)(1)'s reference to a "reasonable profit" support any claim that the Act compels the use of historical costs. *Id.* at 19-20. As the Eighth Circuit succinctly stated, "[a] 'profit' can be made whether a historical cost or a forward-looking cost methodology is used." *Iowa Utils. Bd. v. FCC*, 219 F.3d 744, 752 (8th Cir. 2000) ("*IUB II*") (FCC Pet. App. 13a).

The ILECs also contend that the Act's provision for pricing the transport and termination of traffic, Section 252(d)(2), further demonstrates that the Act requires historical costs. BellSouth Br. at 15. That provision, like the wholesale pricing provision, does not endorse a particular cost methodology, and the FCC concluded that the pricing of transport and termination under Section 252(d)(2) "should be based on the same cost-based standard" as the pricing provisions for network elements and interconnection in Section 252(d)(1). JA 439-441 (¶¶ 1054-1056). This argument, therefore, circles back to the same path and again demonstrates that the Act's UNE pricing provision is ambiguous.

Qwest argues that if Congress intended for network element prices to be based on the cost of the most efficient network, "it could have, and would have, used language to that effect." Qwest Br. at 16. This analysis misses the mark. Congressional silence on the precise cost methodology to be used empowers the expert agency to make that determination. As this Court held, "Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 397 (1999) ("*IUB I*"). If Congress intended to prohibit the FCC from using particular methodologies to implement the Act's pricing requirements,

it would have legislated with more precision. Instead, Congress used the ambiguous terms "cost" and "just and reasonable." This Court has long held that a statutory requirement of "just and reasonable" rates allows an agency to select either a forward-looking or a historical cost methodology. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). *See also IUB II*, 219 F.3d at 751-52 (FCC Pet. App. 11a) (holding that "cost" is an ambiguous term); *Capital Network Sys., Inc. v. FCC*, 28 F.3d 201, 204 (D.C. Cir. 1994) (a statutory requirement of "just and reasonable" rates has long been understood to be ambiguous and to afford "substantial deference" to the implementing agency); Sprint Pet'r Br. at 13-20.

The ILECs also argue that the language in Section 252(d)(1) requiring UNE rates to be "based on the cost . . . of providing the . . . network element" necessarily refers to an ILEC's existing network. Thus, they contend, the reference to "cost" must mean the ILEC's historical costs to build its network. BellSouth Br. at 14-15; Qwest Br. at 15. This misconstrues the statutory language. By focusing on the "cost of . . . providing" the network element, the statutory language directs the inquiry to the economic costs resulting from the new entrant's use of the network element today and not the original price paid by the ILEC when the network was first built. Rather than base the price of network elements on obsolete or inefficient equipment that no one would purchase, the FCC's most efficient network rule reasonably measures the "cost of . . . providing" the UNE based on what the ILEC or any other carrier would pay in the marketplace today to provide the same functionalities. When properly read in full context, therefore, the statutory language not only allows for, but supports, use of a forward-looking methodology based on the least cost, most efficient technology available.

The ILECs attempt to demonstrate that the Act requires a historical cost methodology through a hypothetical example

involving shipbuilding. They posit that if Congress required Newport News Shipbuilding ("NNS") to build a carrier, and Congress promised to pay the cost of providing the carrier, the Defense Department could not refuse to pay the costs NNS necessarily incurs and instead pay what it hypothesizes would be the costs if the whole shipyard were rebuilt from scratch. BellSouth Br. at 16. This analogy is flawed and only underscores the entrenched monopoly viewpoint of the ILECs. The Act does not require the ILECs to construct whole new networks. It only requires that they share existing elements of those networks based on rates that replicate a competitive marketplace. TELRIC properly measures those rates based on what it would cost an ILEC today to provide the UNE functions using the least cost, most efficient technology. Any actor facing competition would be required to price its offerings based on the same considerations, and not simply based on whatever costs it would like to pass on to its customers. While it may be difficult for the ILECs to adjust to this competitive approach, Congress certainly intended to create such an environment under the Act.

Finally, the ILECs rely on selected portions of the legislative history as support for the use of historical costs. Qwest Br. at 16; BellSouth Br. at 16 n.13. The cited legislative history makes no reference to any particular measure of cost. Indeed, the very same Senate Report cited by the ILECs states that "the State may not use or require a rate of return or other rate based proceeding to determine the cost of an unbundled element." S. Rep. No. 104-23, at 21 (1995). This language was ultimately incorporated into Section 252(d)(1)(A)(i), which expressly precludes any reference "to rate-of-return or other rate-based proceeding . . ." in establishing UNE prices. Because these kinds of proceedings typically use an ILEC's historical costs, one must infer that Congress did not intend for UNE prices to be based on historical costs.

B. The FCC's Selection Of A Cost Methodology Based On The Most Efficient Replacement Technology Was Reasonable And Rule 505(b)(1) Should Be Reinstated.

1. Rule 505(b)(1) Simulates The Real World Costs To A New Entrant In A Competitive Environment.

The ILECs contend that Rule 505(b)(1) will not measure cost accurately because a new entrant would never be able to acquire a least cost, most efficient network "in the real world." They argue that telephone companies do not replace all of their equipment instantaneously, but instead use "anticipatory retardation" to replace equipment over time. They also contend that their ability to implement new, efficient technologies is constrained by "path dependency," which limits their choices because of the need to ensure compatibility with existing brands of equipment.[2] BellSouth Br. at 26-29; Qwest Br. at 31-33.

The ILECs' claims are based on the faulty premise that new entrants must bear the cost of the ILECs' prior strategic choices. The FCC elected to measure the cost of providing UNEs by examining what a new entrant would pay in the marketplace today to replace the functions at issue with efficient substitutes that can be used consistently with the location of the ILEC's existing wire centers. Even if it can be assumed that an ILEC chose not to deploy the most efficient equipment available because of "path dependency," in a competitive market the ILEC still would be forced to price its services against a competitor using such equipment. The

[2] Given the fact that ILECs account for an overwhelming share of the demand for new telephone equipment, it can be reasonably assumed that equipment vendors already consider "path dependency" concerns when designing their new products in order to maximize demand. The ILECs' "path dependency" concerns, therefore, are likely more theoretical than real.

ILEC's UNE prices would thus mirror its pricing behavior in the retail market. The FCC's choice of a methodology that incorporates these principles is certainly "within the bounds of the reasonable." *IUB I*, 525 U.S. at 395; *Chevron U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 865 (1984).

The ILECs further claim that the FCC's cost methodology assumes a market for network elements when none exists. BellSouth Br. at 19-20. Because no market exists, they contend, it is a theoretical exercise to try to calculate a forward-looking rate for UNEs. *Id.* This argument wrongly presumes that other cost methodologies—such as ones based on historical costs—are less theoretical than a forward-looking cost methodology. As shown in Sprint's earlier briefs, regulators have increasingly found forward-looking cost methodologies to be more reliable and practical than historical cost models. *See* Michael K. Kellogg *et al.*, *Federal Telecommunications Law* § 9.2 (1st ed. 1992) ("In practice, rate of return regulation usually culminates in poor regulation of cost, with prices allowed to float upward."); Sprint Resp't Br. at 23. The FCC also made a reasoned determination that TELRIC could be implemented based on the proven experience of the state commissions. JA 334-336, 381 (¶¶ 631, 681). That determination has been confirmed by the successful use of TELRIC—including Rule 505(b)(1)'s "most efficient replacement cost" component—by state commissions around the country.

The ILECs similarly contend that "no rational new entrant would enter" the market with a most efficient network on the terms posited by the FCC. BellSouth Br. at 28. They assert that a rational new entrant would price UNEs at a level above the most efficient replacement cost—demanding a higher rate of return by charging prices well above TELRIC during the time it had a competitive advantage. *Id.* at 29; Qwest Br. at 33. They believe that the ability to gain a price advantage is the key incentive to use a new technology and that the FCC

erred in assuming that an "instantaneous" price reduction would occur. Qwest Br. at 33.[3]

The FCC was not attempting to "simulate a theoretically perfect market through regulation," as the ILECs wrongly suggest. *Id.* at 21. Rather, the FCC selected a methodology that it determined would best replicate competitive market conditions. At the same time, the FCC sought to ensure that the rates eventually produced by that methodology would encourage new entrants to build competing facilities without stifling competition from the outset. JA 383-384 (¶ 685). The agency concluded that TELRIC "give[s] appropriate signals to producers and consumers and ensure[s] efficient entry and utilization of the telecommunications infrastructure." JA 333 (¶ 630). Rule 505(b)(1)'s network configuration requirement is a reasonable and necessary component of that methodology. In contrast, the FCC determined that the use of historical costs would force competitors to pay for the existing inefficiency of the ILECs' networks and would not "ensure the efficient investment decisions and competitive entry . . . contemplated by the 1996 Act." JA 399 (¶ 705). The agency thus concluded that use of the ILECs' preferred methodology, not TELRIC, would discourage any "rational new entrant" from entering the

---

[3] The ILECs argue that this "problem" is not ameliorated by the fact that most interconnection agreements are for three year terms. They contend that technologies and prices are not actually "locked in" for a three year period because the "pick and choose" rule permits CLECs to adopt different prices at any time, and interconnection agreements expire at different times. Qwest Br. at 36; BellSouth Br. at 33 n.25. These concerns are overstated and the ILECs conveniently ignore the fact that most states have conducted generic or consolidated proceedings involving all interested parties to establish industry-wide UNE prices for multi-year periods. *See, e.g., U S W. Communications, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1009-10 (D. Ariz. 1999); *Southwestern Bell Tel. Co. v. AT&T Communications of the Southwest, Inc.*, No. 97-D-CA-132, 1998 U.S. Dist. LEXIS 15,637, at *8, *33-*34 (W.D. Tex. Aug. 31, 1998).

market. That determination was well-supported and should be affirmed.

2. Rule 505(b)(1) Encourages Facilities-Based Competition.

Qwest contends that Rule 505(b)(1) discourages facilities-based investment by CLECs and thus detracts from Congress' goal of a deregulated local market. Qwest Br. at 23-24. In the "real world," Qwest argues, there is no such thing as a "most efficient, least cost provider." By establishing UNE rates based on this hypothetical provider, Rule 505(b)(1) will "always" make it more attractive for new entrants to lease UNEs rather than to build their own competitive facilities or to lease the same functionalities from a third party. *Id.* at 23-26.

Qwest conveniently ignores the fact that Rule 505(b)(1) incorporates an ILEC's existing wire centers and does not presume the most efficient, least cost provider in the truest sense. The FCC reasonably concluded that including this component as part of the TELRIC cost methodology would provide incentives to new entrants to construct their own facilities, using a more efficient network architecture. JA 383-384 (¶ 685); Sprint Pet'r Br. at 19. Moreover, new entrants have incentives to offer service through their own facilities in order to avoid potential discrimination from the ILEC, *see* JA 299-300 (¶ 307), and to offer innovative services. In order to maintain market share, ILECs will also have incentives to invest in new facilities to compete with innovative services offered by CLECs. By stimulating competition, therefore, the FCC's "most efficient network" rule promotes innovation and does not discourage new investments by ILECs, as Qwest wrongly argues. Qwest Br. at 27.

Qwest's argument also mistakenly assumes that a CLEC offering local service through UNEs will incur lower costs

than a CLEC offering those same services through its own facilities in all cases and at all times. *Id.* at 23-25. There is nothing in the record to support that contention. Nor is there any basis to conclude that a new entrant serving customers through its own facilities would be at a disadvantage with other new entrants serving customers through leased UNEs. Were this the case, there would be a greater percentage of new entrants servicing local customers through leased network elements. Recent FCC data, however, indicates that no single method of competitive entry predominates. Industry Analysis Division, FCC, *Local Telephone Competition: Status as of December 31, 2000* (May 2001).

3. The FCC's Cost Methodology Fairly Compensates ILECs For The Costs Of Providing UNEs.

The ILECs next contend that, by adopting Rule 505(b)(1), the FCC has "knowingly" deprived them of the ability to recover their costs. In particular, they argue that the FCC's treatment of rates of return and depreciation in TELRIC is arbitrary and capricious because it was based on the erroneous conclusion that ILECs "did not yet face significant facilities-based competition in the real world." BellSouth Br. at 30-31. The ILECs claim that the FCC "whipsawed" them by assuming that facilities would be instantaneously replaced while ignoring "the astronomical rates of return and depreciation expenses that would prevail in such a world." *Id.* at 31.

The ILECs' claims are overblown, if not disingenuous. In adopting TELRIC, the FCC used currently authorized rates of return as a starting point and specifically instructed the state commissions to account for the effects of competition on ILECs in setting the depreciation rates and cost of capital. JA 395-396 (¶ 702). Under this approach, "[s]tates may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of

capital is warranted," due to emerging competition and other factors. JA 396 (¶ 702). The FCC thus considered "real world" market conditions and gave the state commissions effective means to adjust for them in establishing UNE prices. Moreover, in the "real world" five years after the Act's passage, the ILECs still maintain over 92% of the local telecommunications market. Sprint Resp't Br. at 34. The ILECs cannot credibly claim that the FCC erred by failing to assume that they faced "significant facilities-based competition."

The ILECs further contend that it was arbitrary and capricious for the FCC to incorporate their existing wire center locations into Rule 505(b)(1) without including other aspects of their existing networks, such as telephone poles. BellSouth Br. at 23; Qwest Br. at 28. In fact, the FCC could have adopted a least cost, most efficient methodology that did not make *any* allowances for the inefficiencies of the incumbents' networks. After fully analyzing several alternatives, however, the FCC determined that incorporating existing wire centers into the cost methodology would provide proper incentives for CLECs to invest in their own facilities without overloading UNE prices with the inefficiencies of an ILEC's network. JA 382-384 (¶¶ 683-685). The agency concluded that this approach was the best way to promote competition and to encourage innovation. That determination was not irrational and should be upheld.

Finally, Qwest alone acknowledges that forward-looking methodologies are permissible, but argues that TELRIC is flawed because it does not base costs on the ILEC's "existing" network. Qwest Br. at 38-41. This approach, as the FCC correctly found, would be essentially an embedded cost methodology and would require CLECs to pay for the existing inefficiencies and obsolescence of the ILEC's network. JA 383 (¶ 684). The FCC also rejected the efficient component pricing rule ("ECPR") advocated by Qwest after finding that ECPR would inflate network element costs by

providing purported "lost profits" to the ILECs. JA 401-402 (¶¶ 708-710). Qwest now suggests that using price caps to determine network element prices would be appropriate. Qwest Br. at 40-41. Price caps are not cost-based. The FCC applied a price cap methodology to calculate access rates in the 1990s, in an attempt to introduce more efficiency incentives in the pricing of access. However, price cap regulation does not eliminate the ILECs' incentives to include inappropriate investments on their books, was largely abandoned by the FCC last year, and, in all events, would not comply with the Act's mandate that UNE prices be cost-based.

C. Rule 505(b)(1) Does Not Raise "Serious Constitutional Questions" Of A Takings Violation.

The ILECs use their challenge to Rule 505(b)(1) to reargue that denying them historical costs would raise "serious constitutional questions" under the Takings Clause. BellSouth Br. at 36. They contend that a forward-looking methodology based on the most efficient replacement cost forces them to "operate at a loss" and that a constitutional problem can only be avoided by adopting a pricing methodology that authorizes recovery of all historical costs. *Id.* at 36-38.

The FCC's adoption of Rule 505(b)(1) does not raise a serious constitutional question, for the reasons shown in Sprint's Brief in Support of the FCC Respondents. Sprint Resp't Br. at 28-43. Most notably, the ILECs have not shown—and cannot show—that the "total effect" of TELRIC rates is so unjust as to be confiscatory. *Id.* at 34-39. Nor can the ILECs avoid the "total effect" test by claiming that state commissions are unable to determine UNE prices because there is no "market" for network elements. BellSouth Br. at 38-39. State commissions have been able to determine the value of the underlying components, labor, and material that make up the network elements, which provides an adequate basis for establishing the rates.

The ILECs also wrongly claim that they were promised "full-cost recovery at a utility rate of return" and that the "breaking" of this promise raises serious takings questions. *Id.* at 40. Yet, this Court has repeatedly held that reasonable investors are not entitled to expect an existing ratemaking scheme to be permanent or to claim entitlement to particular regulatory treatment. *E.g.*, *Tennessee Elec. Power Co. v. Tennessee Valley Auth.*, 306 U.S. 118, 141 (1939); *see also American Trucking Ass'ns, Inc. v. Atchison, Topeka & Santa Fe Ry.*, 387 U.S. 397, 416 (1967). *Cf. New York Cent. R.R. v. White*, 243 U.S. 188, 198 (1917) ("No person has a vested interest in any rule of law, entitling him to insist that it shall remain unchanged for his benefit."). The ILECs have no greater entitlement here. The FCC was authorized to determine the appropriate cost methodology to implement the Act's new regulatory regime. The FCC did not "break" any regulatory promise to the ILECs in carrying out its new mandate from Congress.

II. REQUIRING ILECs TO COMBINE NETWORK ELEMENTS DOES NOT VIOLATE SECTION 251(c)(3) OF THE ACT.

A. Section 251(c)(3) Is Ambiguous.

The ILECs argue that the "plain language" of Section 251(c)(3) forecloses CLECs from leasing UNEs "in combination" unless the network elements are already combined in the ILEC's network. *See* BellSouth Br. at 41-49. They focus solely on the portion of the statute that reads "'in a manner that allows requesting carriers to combine such elements,'" arguing that the "plain assumption" to be drawn from this language is that CLECs themselves must combine the UNEs. *Id.* at 48 (citation omitted). Accordingly, the ILECs contend that Rule 315(c)-(f), which allows CLECs to request UNE combinations where technically feasible, violates the Act.

This Court previously held that the language of Section 251(c)(3) is ambiguous. In reinstating Rule 315(b) as a reasonable interpretation of the statute, this Court ruled that although UNEs may be requested in "discrete pieces," the statutory language "does not say, or even remotely imply, that elements *must* be provided only in this fashion and never in combined form." *IUB I*, 525 U.S. at 394 (emphasis in original). The ILECs attempt to distinguish this Court's interpretation of Section 251(c)(3) by arguing that a rule prohibiting ILECs from separating already combined UNEs "is very different" from a rule requiring ILECs to combine UNEs upon request. BellSouth Br. at 44. In practical effect, however, Rule 315(b) and Rule 315(c)-(f) are opposite sides of the same coin. Both rules are designed to ensure that CLECs are able to obtain UNEs in a manner that permits them to provide competitive local services, as Congress intended. JA 297-298 (¶ 296). Rule 315(b) precludes ILECs from separating already combined UNEs because, as both the FCC and this Court recognized, doing so would unnecessarily increase a CLEC's costs in leasing the elements. This Court concluded that the agency was right to prohibit such an anti-competitive practice. *IUB I*, 525 U.S. at 394-95. Rule 315(c)-(f) accomplishes the same objectives, by requiring ILECs to combine UNEs for CLECs when it is technically feasible to do so. JA 297-298 (¶ 296). The FCC determined that this approach was necessary "given the practical difficulties of requiring requesting carriers to combine elements that are part of the incumbent LEC's network." JA 296 (¶ 294). The agency correctly found that it would be more efficient and reliable for the ILECs who own and control the networks to do the combining. The CLECs, in turn, must pay the ILECs for this service. Absent such a rule, the FCC found, "requesting carriers would be seriously and unfairly inhibited in their ability to use unbundled elements to enter local markets." *Id.* (¶ 293).

Ironically, the ILECs have vigorously objected to providing physical access to their networks in other contexts. *Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. 3696, 3910 (¶ 482) (1999). Under the UNE combinations rule, the ILECs keep control of their networks and are to be fairly compensated for providing combining services to CLECs. The only reason an ILEC would object to the rule under these circumstances is to impede access to UNEs and to increase new entrants' costs. As this Court found in *IUB I*, the FCC was right to prohibit such anti-competitive practices.

The ILECs also attempt to argue that Rule 315(c)-(f) is more akin to the "superior quality" rules that were vacated by the Eighth Circuit than to Rule 315(b). BellSouth Br. at 47. This analogy is flawed. The "superior quality" rules required ILECs to provide interconnection and unbundled access at levels of quality superior to those at which they provided such services to themselves. The Eighth Circuit found that these rules violated the plain language of Section 251(c)(2)(C), which only requires ILECs to provide interconnection that is at least equal in quality and thus "establishes a floor below which the quality of interconnection may not go." *Iowa Utils. Bd. v. FCC*, 120 F.3d 753, 812 (8th Cir. 1997), *aff'd in part and rev'd in part sub nom. AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999). In contrast, Rule 315(c)-(f) is designed to deter anti-competitive conduct and to ensure meaningful access to an ILEC's existing network facilities. The rule only requires that an ILEC combine UNEs when it is technically feasible to do so. Under this standard, the ILEC is equally capable of combining the UNEs for its own use as it is for a requesting CLEC. Nothing in the rule requires the ILEC to provide any service to a CLEC that is "superior" to what the ILEC can currently provide to itself.

B. The UNE Combinations Rule Is Reasonable And Necessary To Ensure Meaningful UNE Access.

The ILECs next argue that Rule 315(c)-(f) is unreasonable because there is nothing "discriminatory" about requiring CLECs to combine UNEs. BellSouth Br. at 45. As shown, the FCC found to the contrary. Based on the record, the FCC logically concluded that CLECs were not on equal footing with ILECs in obtaining access to the ILECs' networks and that "in practice it would be impossible for new entrants that lack facilities and information about the incumbent's network to combine unbundled elements." JA 296 (¶ 293). As a consequence, the agency determined that CLECs would be unable to offer local services using UNEs on the same level as the ILEC without the combinations rule.

Because Section 251(c)(3) is ambiguous, the FCC was authorized to interpret the statute in light of these policy concerns. *IUB I*, 525 U.S. at 394-95. Experience has proven that these concerns were well-founded. Some ILECs still refuse to provide access to network elements so that CLECs can combine them, effectively defeating the statutory intent. *Implementation of the Local Competition Provisions of the Telecomms. Act of 1996*, 15 F.C.C.R. at 3910 (¶ 482). Attempts by CLECs to obtain access to networks to combine UNEs have also proven to be unworkable and easily obstructed by ILECs. The CLECs' experiences in Colorado are illustrative. The Colorado state commission rejected an ILEC proposal that would "allow" CLECs to combine network elements. The Colorado commission concluded that the proposal "does not provide a reasonable opportunity for CLECs to combine UNEs and thus creates an unnecessary barrier to the development of competition in Colorado." *Investigation and Suspension of Tariff Sheets Filed by U S W. Communications, Inc.*, Docket No. 96S-331T, Decision No. C98-1047 at 13-15 (Colo. Pub. Utils. Comm'n Oct. 1, 1998). One witness explained "that with [an ILEC's] modern

telephone network, loops or trunks are 'moved' electronically through software, and to propose anything different would be to move backwards through time and technology." *Id.* at 12. Based on these and other problems, the Colorado commission found that the ILEC's proposal was "discriminatory," "inefficient," and would cause "unnecessary service disruption to customers." *Id.* at 13-16.

The ILECs also argue that the combinations rule is infected with the same improper analysis underlying the FCC's original Rule 319, which identified the UNEs subject to the access requirements of Section 251(c)(3). In *IUB I*, this Court held that the FCC "did not adequately consider the 'necessary and impair' standards" of Section 251(d)(2) in determining which UNEs must be made available by ILECs. 525 U.S. at 387-88. The Court found that the "necessary and impair" standard meant something more than simply showing that a CLEC would incur higher costs without access to a UNE and that such access was "technically feasible." *Id.* at 390-92.

A determination of which UNEs must be unbundled is different from a determination that ILECs should be required to combine UNEs upon request. The statutory standard prescribed by Congress for the former examines whether particular UNEs are necessary for new entrants to compete. This involves, among other things, consideration of available substitutes for the same functionalities in the marketplace. The statutory duty prescribed by Congress for the latter requires that CLECs be afforded meaningful *access* to the requisite UNEs, once identified. The FCC found that Rule 315(c)-(f) was necessary to ensure such access. Without it, the pro-competitive goals underlying both Sections 251(c)(3) and 251(d)(2) are defeated.[4]

---

[4] The ILECs attempt to equate the FCC's concerns over an ILEC's ability to impose wasteful costs on CLECs by forcing them to combine UNEs with the FCC's discredited view that any cost savings to a CLEC

The ILECs cite to the FCC's reference to "technical feasibility" in Paragraph 296 of the *Local Competition Order* as evidence that the agency's analysis of Rule 315(c)-(f) was tainted by the same analysis underlying Rule 319. A fair reading of the agency's discussion proves otherwise. The FCC was reasonably concerned that "network reliability and security factors" may make it technically infeasible for an ILEC to combine UNEs in certain circumstances, even when the individual elements must be made available on an unbundled basis. The agency's provision for this practical possibility in no way undermines the general conclusion that the combinations rule is necessary both to afford CLECs meaningful access to UNEs and to prevent discriminatory practices by ILECs.

The ILECs also wrongly claim that the FCC "acknowledged" that its "technical feasibility standard for additional combinations 'is consistent with the [FCC's] *method* . . . adopted to identify unbundled network elements.'" BellSouth Br. at 46 (citing Paragraph 295 of the *Local Competition Order)* (emphasis added). This again takes the agency's discussion out of context. In the quoted paragraph, the FCC explained that the combinations rule is consistent with the agency's general definitional approach to determining what constitutes a "network element," which may include several parts. JA 297 (¶ 295). As stated by the agency:

> Under our method, incumbents must provide, as a single, combined element, facilities that could comprise more than one element. . . . [F]or example, . . . if the states

---

satisfied the "necessary and impair" standard under Rule 319. BellSouth Br. at 49. This argument is equally strained. The combinations rule is designed to ensure that CLECs have meaningful access to UNEs *and* to prevent ILECs from imposing "wasteful" costs. Either objective would support the rule and this Court already found that protecting CLECs from "wasteful" costs was a reasonable basis for Rule 315(b). *IUB I*, 525 U.S. at 395.

> require incumbent LECs to provision subloop elements, incumbent LECs must still provision a local loop as a single, combined element when so requested, because we identify local loops as a single element in this proceeding.

Id. This Court upheld the FCC's "method" of determining which equipment and features of an ILEC's system constitute "network elements" under Section 251(d)(2). The Court found that the agency's approach was "eminently reasonable," particularly in view of "the breadth of [the Act's] definition" of a "network element." *IUB I*, 525 U.S. at 387. The same deference should be afforded to the FCC's determinations underlying the combinations rule.

Finally, the ILECs' reliance on *GTE Service Corp. v. FCC*, 205 F.3d 416, 424 (D.C. Cir. 2000) is misplaced. In that case, the D.C. Circuit evaluated whether particular aspects of the FCC's collocation rules complied with the "necessary" standard prescribed in Section 251(c)(6). The D.C. Circuit upheld many of the FCC's collocation rules as reasonable under *Chevron*. For example, the court upheld a rule that prohibited ILECs from charging new entrants the entire cost of site preparation and required the ILECs to allocate the costs based on the space actually used by the particular CLEC. The court found that this rule was "a reasonable way to ensure that LECs do not impose prohibitive requirements on new competitors and thus kill competition before it ever gets started." *Id.* at 427. The D.C. Circuit's reasoning supports a similar finding that Rule 315(c)-(f) is "a reasonable way" to ensure that new entrants can compete in the local telecommunications market by having meaningful access to network elements.

C. Review Of The Combinations Rule Was Not Waived.

The ILECs contend that this Court should not address the validity of Rule 315(c)-(f) because the challenge was not

preserved in *IUB I*. This argument ignores subsequent history. Although this Court did not review Rule 315(c)-(f) in its decision, the Eighth Circuit on remand ordered the parties to address "whether or not, in light of the Supreme Court's decision, this court should take any further action with respect to . . . § 51.315(c)-(f) . . . ." *Iowa Utils. Bd. v. FCC*, Nos. 96-3321 *et al.*, Order at 2-3 (8th Cir. June 10, 1999). The Eighth Circuit then reviewed its prior determination and upheld its vacation of Rule 315(c)-(f) *on the merits*. *IUB II*, 219 F.3d at 758-59 (FCC Pet. App. 26a-29a).

This Court granted *certiorari* on "[w]hether 47 U.S.C. [§] 251(c)(3) prohibits regulators from requiring that incumbent local telephone companies combine certain previously uncombined network elements when a new entrant requests the combination and agrees to compensate the incumbent for performing that task." *Verizon Communications, Inc. v. FCC*, 121 S. Ct. 877 (2001). The question presented goes to the merits of the combinations rule and is based on the Eighth Circuit's most recent decision. *Cf.* Sup. Ct. R. 19.4 ("If the Court orders that the case be briefed or set for argument, the parties shall be notified and permitted to file briefs."). It borders on the frivolous to argue that the issue was waived under these circumstances.

The ILECs cite to *Communist Party of the United States v. Subversive Activities Control Board*, 367 U.S. 1 (1961) in support of their waiver argument. *Communist Party* involved a challenge to an agency order on a procedural ground that was not raised in the first appeal. The Court found that it would be improper to allow a party to gain an advantage as a result of procedural gamesmanship. *Id.* at 30-31. The question presented here, in contrast, involves a substantive issue that affects the entire telecommunications industry, was reconsidered on the merits by the Eighth Circuit on remand, and has been accepted for review by this Court. Moreover, review of the question by this Court will resolve a conflict

between the courts of appeals over the lawfulness of the combinations rule under Section 251(c)(3). *See* WorldCom, Inc.'s Pet. at 23-27. No party will be disadvantaged by review of the issue under these circumstances.

CONCLUSION

For the foregoing reasons, Sprint respectfully requests that this Court reinstate 47 C.F.R. § 51.505(b)(1) and 47 C.F.R. § 51.315(c)-(f).

Respectfully submitted,

DAVID P. MURRAY
Counsel of Record
RANDY J. BRANITSKY
KEVIN M. MILLER
WILLKIE FARR & GALLAGHER
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

Counsel for Respondent
Sprint Corporation

(8)

No. 00-511

Supreme Court, U.S.
FILED
JUN 8 2001
CLERK

IN THE

Supreme Court of the United States

JUN 8 2001

VERIZON COMMUNICATIONS INC., *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND
THE UNITED STATES OF AMERICA,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF *AMICI CURIAE* FOR ALLEGIANCE TELECOM, INC., DSLnet COMMUNICATIONS, LLC, EL PASO NETWORKS, LLC, MPOWER COMMUNICATIONS CORP., PACWEST TELECOM, INC. AND US LEC CORP. SUPPORTING RESPONDENTS

MARY C. ALBERT
Vice President, Regulatory and Interconnection
MORTON J. POSNER
Regulatory Counsel
ALLEGIANCE TELECOM, INC.
1150 Connecticut Avenue, N.W.
Suite 205
Washington, D.C. 20036
(202) 464-6106
Counsel for Allegiance Telecom, Inc.

ANDREW D. LIPMAN
ERIC J. BRANFMAN
HARISHA J. BASTIAMPILLAI *
SWIDLER BERLIN SHEREFF FRIEDMAN, LLP
3000 K Street, N.W.
Suite 300
Washington, D.C. 20007
(202) 424-7500
Counsel for Amici Curiae
Counsel of Record *

June 8, 2001

[Additional Counsel Listed On Inside Cover]

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

BEST AVAILABLE COPY

40 pp

STEPHEN ZAMANSKY
General Counsel
DSLNET COMMUNICATIONS, LLC
545 Long Wharf Drive, 5th Floor
New Haven, Connecticut 06511
(203) 772-1000

Counsel for DSLnet Communications, LLC

RUSSELL I. ZUCKERMAN
Senior Vice President &
General Counsel
RICHARD E. HEATTER
Vice President, Legal Affairs
FRANCIS D. R. COLEMAN
Vice President, Regulatory
Affairs
MPOWER COMMUNICATIONS
CORP.
175 Sully's Trail - Suite 300
Pittsford, New York 14534
(716) 218-6568

Counsel for Mpower Communications Corp.

ROBERT W. BAKER
Vice President and
General Counsel
EL PASO NETWORKS, LLC
1001 Louisiana Street
25th Floor
Houston, Texas 77002
(713) 420-7021

Counsel for El Paso Networks, LLC

SUMNER N. SMITH
Senior Corporate Counsel
US LEC CORP.
6801 Morrison Boulevard
Charlotte, N.C. 28211
(704) 319-1119

Counsel for US LEC Corp.

BEST AVAILABLE COPY

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	iii
STATEMENT OF AMICI INTEREST	1
SUMMARY OF ARGUMENT	2
ARGUMENT	4
I. THE FCC'S CHOICE OF FORWARD-LOOKING COSTS OVER HISTORICAL COSTS WAS REASONABLE AND SHOULD BE ACCORDED DEFERENCE	4
A. The Meaning of Cost	4
B. The Commission's Interpretation Is Entitled to Deference	7
1. TELRIC Is Neither Novel Nor Extreme	7
2. TELRIC Is Capable of Practical Implementation	11
3. The FCC's Interpretation of "Cost" Is Consistent With The Legislative History of the Act	13
II. THE FCC'S TELRIC METHODOLOGY PROVIDES CONSTITUTIONALLY ADEQUATE COMPENSATION	18
A. The Takings Standard	18
B. The RBOCs' Stranded Cost Argument	19
C. The RBOCs Were Adequately Compensated, And Will Continue To Be Adequately Compensated, For Their Historical Costs	22

TABLE OF CONTENTS—Continued

	Page
III. INVALIDATING TELRIC AT THIS STAGE WOULD UNDO THE COMPETITIVE ADVANTAGES MADE SINCE 1996	26
CONCLUSION	30

TABLE OF AUTHORITIES

CASES	Page
Alabama Elec. Co-op, Inc. v. FERC, 684 F.2d 20 (D.C. Cir. 1982)	5
American Public Gas Ass'n v. FPC, 567 F.2d 1016 (D.C. Cir. 1977)	11
Arkansas Power & Light Co. v. I.C.C., 831 F.2d 569 (5th Cir. 1987)	8
AT&T Corporation v. Iowa Utilities Board, 525 U.S. 366 (1999)	5, 6, 16
Atlantic Mutual Insurance Co. v. Commissioner of Internal Revenue, 523 U.S. 382 (1998)	7
Burlington Northern R. Co. v. Surface Transp. Bd., 114 F.3d 206 (D.C.Cir. 1997)	7
Burlington Northern R. Co. v. I.C.C., 985 F.2d 589 (D.C.Cir. 1993)	8
Charles River Bridge v. Proprietors of the Warren Bridge, 36 U.S. (11 Pet.) 420 (1837)	20
Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc., 467 U.S. 837 (1984)	2, 7, 13
Consolidated Rail Corp. v. U.S., 812 F.2d 1444 (3rd Cir. 1987)	8
Duquesne Light Company v. Barasch, 488 U.S. 299 (1989)	*passim*
Federal Power Commission v. Hope Natural Gas, 320 U.S. 591 (1944)	8
Heckler v. Community Health Services of Crawford County, Inc., 467 U.S. 51 (1984)	20
Illinois Bell Telephone Company v. FCC, 988 F.2d 1254 (D.C.Cir. 1993)	6, 19
Iowa Utilities Board v. FCC, 219 F.3d 744 (8th Cir. 2000)	5, 6
Keefe v. Clark, 322 U.S. 393 (1944)	20
MidAmerican Energy Co. v. Surface Transp. Bd., 169 F.3d 1099 (8th Cir. 1999)	7

TABLE OF AUTHORITIES—Continued

	Page
National R.R. Passenger Corp. v. Atchinson, Topeka, & Santa Fe Ry., 470 U.S. 451 (1985)...	20
National R.R. Passenger Corp. v. Boston and Maine Corp., 503 U.S. 407 (1992)	26
Permian Basin Area Rate Cases, 390 U.S. 747 (1968).....	5
Qwest Corporation v. U.S., 48 Fed.Cl. 672 (2001).....	26
Smyth v. Ames, 169 U.S. 466 (1898).....	8
State of Missouri ex rel Southwestern Bell Telephone Co. v. Public Service Commission, 262 U.S. 276 (1923).....	8
Stone v. Wisconsin, 94 U.S. 181 (1876).....	20
Strickland v. Commissioner, Maine Dept. of Human Services, 96 F.3d 542 (1st Cir. 1996)....	5
Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393 (5th Cir. 1999), *cert. dismissed*, 121 S.Ct. 423 (2000).....	21
Town of Norwood v. FERC, 53 F.3d 377 (D.C. Cir. 1995).....	12
United States v. Grand River Dam Auth., 363 U.S. 229 (1960).....	20
US WEST Communications, Inc. v. Arizona Corporation Commission, 3 P.3d 936 (Ariz. Ct. App. 1999).....	21
STATUTES	
47 U.S.C. § 252(d)(1)(A)(i)	4, 6
ADMINISTRATIVE AGENCY ORDERS	
Application of Verizon New England Inc., et al., for Authorization to Provide In-Region, InterLATA Services in Massachusetts, CC Docket No. 01-9, Memorandum Opinion and Order, FCC 01-130 (Apr. 16, 2001).....	24

TABLE OF AUTHORITIES—Continued

	Page
Standards and Safeguards for Competitive Services, Decision, 1995 WL 933715 (Pa. PUC 1995)	10
DPUC Investigation into the Southern New England Tel. Co.'s Cost of Providing Service, Decision, 1995 WL 509180 (Conn. DPUC 1995)	10
Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket 96-98, First Report and Order, 11 F.C.C.R. 15499 (1996)	*passim*
Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (1999).....	18, 28
In re Commission Investigation and Generic Proceeding on Ameritech Indiana's Rates for Interconnection, Unbundled Elements, and Transport and Termination Under the Telecommunications Act of 1996 and related Indiana Statutes, IURC Cause No. 40611, Order, 1998 WL 999945 (1998)	6, 24
In re Investigation Regarding Local Exchange Competition for Telecommunications Services, Docket No. TX95120631, Telecommunications Decision and Order, 1997 WL 795071 (N.J. B.P.U. 1997).....	6
In re Open Network Architecture Tariffs of Bell Operating Companies, Order, 9 FCC Rcd. 440 (1993).....	10

TABLE OF AUTHORITIES—Continued

	Page
In re 800 Data Base Access Tariffs and the 800 Service Management System Tariff and Provision of 800 Services, Report and Order, FCC 96-392, 11 FCC Rcd. 15227 (1996)	10
Investigation of the Communications Infrastructure of the State of Hawaii, Order, 1995 WL 553009 (Hawaii PUC 1995)	10
Methodology to Determine Long Run Incremental Costs, Opinion and Order, 156 P.U.R. 4th 1 (Mich. PUC 1994)	10
Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks, Decision, 1995 WL 790383 (Cal. PUC 1995)	10
Transition to Competition in the Local Exchange Market, NY PSC Case No. 94-C-0095, Opinion No. 96-13, 1996 WL 302398 (1996)	21
LEGISLATIVE MATERIALS	
P.L. 104-104, Telecommunications Act of 1996, S. Conf. Rep. 104-230 (1996)	13
P.L. 104-104, H.R. Rep. 104-204(I) (1995)	13
P.L. 104-104, S. Rep. 104-23 (1995)	26
MISCELLANEOUS	
Association for Local Telecommunications Services, *The State of Local Competition 2001* (February 2001)	17, 29
BellSouth Corporation, Securities and Exchange Commission Form 10-K, Annual Report (Dec. 31, 1995)	22

TABLE OF AUTHORITIES—Continued

	Page
J. Bonbright, *et al.*, *Principles of Public Utility Rates* 109 (2d ed. 1988)	5
W. Baumol and T. Merril, *Deregulatory Takings, Breach of the Regulatory Contract, and the Telecommunications Act of 1996*, 72 N.Y.U. L. Rev. 1037 (1997)	7
Jim Chen, *Standing in the Shadows of Giants: The Role of Intergenerational Equity in Telecommunications Reform*, 71 U. Colo. L. Rev. 921 (2000)	22, 30
David Gabel and David Rosenbaum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239 (2000)	*passim*
Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999)	20
Alfred Kahn & William Shew, *Current Issues in Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191 (1987)	26
Bruce A. Kushnick, *The Unauthorized Bio of the Baby Bells* (1999 ed.)	17
MA DTE Docket No. 01-20, Direct Testimony of Dr. William Taylor on Behalf of Verizon New England d/b/a Verizon Massachusetts (May 4, 2001)	24
NARUC Staff Subcommittee on Communications, *Local Competition Work Group Summary Report* (1996)	21
Proceeding to Determine Permanent Pricing for Unbundled Network Elements, NCUC Docket No. P-100 SUB 133D, Post-Hearing Brief of GTE South Incorporated (1998)	15

STATEMENT OF AMICI INTEREST

Allegiance Telecom, Inc., DSLnet Communications, LLC, El Paso Networks, LLC, Mpower Communications Corp., PacWest Telecom, Inc. and US LEC Corp. are competitive local exchange carriers ("CLECs").[1] *Amici* provide both traditional voice service and advanced telecommunications services such as high-speed data service throughout the United States. *Amici* provide such service both through deployment of their own facilities and leasing of the facilities of incumbent local exchange carriers ("ILECs"). *Amici* are products of the Telecommunications Act of 1996 ("1996 Act") and are the type of facilities-based carriers that Congress envisioned would enter the market as a result of the 1996 Act.

The carriers submit this *Amici Curiae* brief to urge this Court to defer to the reasonable interpretation of the pricing requirements of the Act made by the Federal Communications Commission in its Order implementing the local competition provisions of the Act. *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket 96-98, First Report and Order, 11 F.C.C.R. 15499 (1996) ("*Local Competition Order*"). In that Order, the Federal Communications Commission implemented a forward-looking cost methodology that is designed to promote the development of competition in the local exchange market.

In adopting a forward-looking cost methodology, the FCC chose an approach that would balance the interests of all carriers, and consumers, and meet the pro-competitive goals of the Act. This methodology has assisted *Amici* and other

---

[1] The parties have consented to the filing of this brief. The letters of consent have been filed with the Clerk of the Court. Counsel for parties did not author this brief in whole or in part. No person or entity, other than *Amici*, made a monetary contribution to the preparation and submission of this brief.

CLECs in providing competitive service throughout the United States in an efficient, and cost-effective manner. Adoption of the historical cost approach advocated by the Regional Bell Operating Company ("RBOC") petitioners would undermine this provision of competitive service and imperil the achievement of the goals of the 1996 Act.

Amici have invested substantial time and resources both in proceedings before state public utility commissions developing and applying this methodology, and in making market entry and investment decisions based on this methodology. Invalidation of the FCC's forward-looking cost methodology would have a wide-ranging impact on the telecommunications industry and on *Amici* in particular. Use of the historical cost methodology proposed by the RBOCs would force *Amici* and other CLECs to make the unenviable choice between inefficiently expending even more capital to deploy duplicative facilities or to exit certain markets altogether. Either choice would conflict with the goals articulated by Congress when it enacted the Act.

For these reasons, *Amici* are filing this brief, and respectfully request that this Court consider the important perspective they provide.

SUMMARY OF ARGUMENT

1. Contrary to the assertion of the RBOCs, the meaning of "cost," both under the 1996 Act and in the context of the telecommunications industry, is far from clear, for the term has taken on various meanings throughout the years. Moreover, the 1996 Act fundamentally restructured the industry and transformed whatever notions of "cost" may have existed prior to the Act.

Because the meaning of "cost" is ambiguous, the FCC's interpretation of the meaning of "cost" as forward-looking cost, and its choice of a forward-looking cost methodology, is entitled under *Chevron U.S.A. Inc. v. Natural Resources Defense Counsel, Inc.*, 467 U.S. 837, 843 (1984)("*Chevron*")

to deference if its interpretation is reasonable. The FCC's choice of methodology was neither arbitrary nor capricious, and was eminently reasonable.

The FCC's choice not only was appropriate, but also is the one most consistent with the pro-competitive goals of the 1996 Act. Congress, in enacting the 1996 Act, sought to foster increased competition, reduce consumer prices, and spur deployment of facilities. The FCC's methodology promotes efficient entry of competitors and rational deployment of facilities. The implementation of the FCC's Total Element Long Run Incremental Cost ("TELRIC") methodology has demonstrated that it has worked to make tangible the goals of the Act. The use of TELRIC has spurred significant facility investment by CLECs while at the same time not diminishing the investment ardor of the ILECs. At the same time, TELRIC has ensured that investment is not wasted on the construction by CLECs of duplicative facilities that could be constructed at lower cost by ILECs, but is targeted to broaden the deployment of facilities. The result has been the extension of the reach of competitive telecommunications services at market-based prices.

2. The RBOCs have not demonstrated that FCC's TELRIC methodology fails to provide them constitutionally adequate compensation or imperils their financial integrity. The RBOCs base their Takings Claim on their historical costs that are purportedly left "stranded" or unrecovered as a result of the FCC's asserted switch from an historical cost ratemaking methodology to a forward-looking methodology. The basis for recovery of these costs is rooted in a purported compact federal and state regulators made with the RBOCs that such costs would be recovered.

As this Court has held, however, when one bargains with the state nothing passes by implication and promises are to be narrowly construed. Contrary to the RBOCs' assertions, there has been no assurance from either federal or state regulators that the stranded costs would be recovered, and

there was no basis for such expectations. Even assuming *arguendo* that the RBOCs had a right to recover such costs, they have not demonstrated that these costs were significant, or that the compensation they are provided fails to recover these costs. The RBOCs have failed to show that the reduced rates "jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Duquesne Light Company v. Barasch*, 488 U.S. 299, 312 (1989) ("*Duquesne Light*").

3. Invalidating TELRIC at this time would "strand" the investments of the CLECs. The CLECs made rational economic decisions to enter markets and deploy facilities based upon the FCC's forward-looking methodology. A switch to an historical cost approach would require CLECs either to engage in inefficient overbuilding of facilities or to exit markets. Either approach would result in a situation that is a contrary to the intent of Congress. Replacing TELRIC with an historical cost approach would frustrate the purpose of the 1996 Act.

I. THE FCC'S CHOICE OF FORWARD-LOOKING COSTS OVER HISTORICAL COSTS WAS REASONABLE AND SHOULD BE ACCORDED DEFERENCE

A. The Meaning of Cost

Section 252(d)(1)(A)(I) of the 1996 Act requires that "just and reasonable rates" be set for interconnection and network elements and that these rates be "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." 47 U.S.C. § 252(d)(1)(A)(i) (FCC Pet. App. 118a-119a).[2] In implementing this statutory provision,[3]

[2] Since the parties are using a deferred appendix, citations to statutory provisions and the *Local Competition Order* will be made to the Appendix attached to the FCC's Petition for Writ of Certiorari as (FCC Pet. App. ___).

[3] This Court previously determined that the FCC has jurisdiction to design a pricing methodology to implement this statutory provision. *AT&T Corporation v. Iowa Utilities Board*, 525 U.S. 366, 385 (1999) ("*Iowa Utilities Board*").

the FCC has prescribed that rates be based on a forward-looking, replacement cost method which it terms TELRIC. *Local Competition Order*, ¶¶ 678-690 (FCC Pet. App. 66a-74a). The RBOCs argue that "the plain text, structure, and purpose of Section 252 make it clear that prices must include historical costs." *Brief for Petitioners, Verizon Communications, Inc., et al.*, at 16 ("*Petitioners' Brief*").

The meaning of "cost" in Section 252 is, however, far from clear. The concept of "just and reasonable rates based on cost" is a term in ratemaking for which "neither law nor economics has yet devised generally acceptable standards." *Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968), *accord Alabama Elec. Co-op, Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982)(cost "itself is an inexact standard"). As the court below observed, the word "cost" is a "chameleon" capable of many meanings in the regulatory context. *Iowa Utilities Board v. FCC*, 219 F.3d 744, 752 (8th Cir. 2000) ("*Iowa Utilities Board II*"); *see Strickland v. Commissioner, Maine Dept. of Human Services*, 96 F.3d 542, 546 (1st Cir. 1996)(there is "ambiguity inherent in the word 'cost.'"). Regulatory commissions have construed the term "cost" to support both "historical cost" and forward-looking reproduction cost approaches. *See* J. Bonbright, *et al.*, *Principles of Public Utility Rates* 109 (2d ed. 1988). During the period in which the FCC's pricing rules were vacated, many state commissions independently adopted the TELRIC methodology as the one most in accord with the requirements of the 1996 Act thus further supporting the FCC's

interpretation.[4] The Eighth Circuit thus reasonably concluded the term "cost" in Section 252 is "ambiguous." *Iowa Utilities Board II*, 219 F.3d at 752.

Even assuming *arguendo* that the word "cost" meant "historical" cost in the monopoly era prior to the enactment of the 1996 Act, the Act clearly effected a massive restructuring of the status quo.[5] Thus, even if "cost" meant "historical cost" prior to the 1996 Act, that meaning would have been placed in doubt given the fundamental restructuring effected by the 1996 Act. This is reflected in the admonition in Section 252 that a "rate-of-return or other rate based" methodology *not be used* to determine prices. 47 U.S.C. § 252(d)(1)(A)(i) (FCC Pet. App. 118a-119a). Rate-of-return proceedings are based upon use of historical costs. *See Illinois Bell Telephone Company v. FCC*, 988 F.2d 1254, 1258-59 (D.C.Cir. 1993)("*Illinois Bell*"). To promote competition, Congress clearly intended a departure from traditional costing principles.

---

[4] *See, e.g., In re Commission Investigation and Generic Proceeding on Ameritech Indiana's Rates for Interconnection, Unbundled Elements, and Transport and Termination Under the Telecommunications Act of 1996 and related Indiana Statutes*, Cause No. 40611, Order, 1998 WL 999945, *4 (1998) ("*IURC UNE Order*"); *In re Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket No. TX95120631, Telecommunications Decision and Order, 1997 WL 795071, *8 (N.J. B.P.U. Dec. 2, 1997), *aff'd in part and vacated in part, AT&T Communications of New Jersey, Inc., et al.,v. Bell Atlantic-New Jersey, Inc., et al.; MCI Telecommunications Corp., et al., v. Bell Atlantic-New Jersey, Inc., et al.*, Nos. 97-5762, 98-0109 (D.N.J. June 6, 2000)

[5] As this Court noted:

> The Telecommunications Act of 1996 fundamentally restructures local telephone markets. States may no longer enforce laws that impede competition, and incumbent LECs are subject to a host of duties intended to facilitate market entry.

Iowa Utilities Board, 525 U.S. at 372.

B. The FCC's Interpretation Is Entitled To Deference

If a statute is "silent or ambiguous with respect to the specific issue, the question for this court is whether the agency's answer is based on a permissible construction of the statute." *Chevron*, 467 U.S. at 843. The Court is not to decide whether the agency's interpretation "represents the best interpretation of the statute, but whether it represents a reasonable one." *Atlantic Mutual Insurance Co. v. Commissioner of Internal Revenue*, 523 U.S. 382, 389 (1998). The agency's interpretation will be upheld unless it is arbitrary, capricious, or manifestly contrary to the statute. *Chevron*, 467 U.S. at 843-44.

The FCC's adoption of TELRIC was neither arbitrary nor capricious. Far from being the "novel, complex, difficult to administer," "extreme" methodology that the RBOCs claim it to be, TELRIC is an extension of forward-looking, reproduction cost principles that at one point were widely used, and indeed were considered to be constitutionally mandated.

1. *TELRIC Is Neither Novel Nor Extreme*

TELRIC is a long run incremental cost approach to ratemaking—long favored by regulatory lawyers, economists, and regulators—and is designed to replicate the market prices that would result under competition. W. Baumol and T. Merril, *Deregulatory Takings, Breach of the Regulatory Contract, and the Telecommunications Act of 1996*, 72 N.Y.U. L. Rev. 1037, 1063 (1997). TELRIC closely resembles the "Stand-Alone Cost" methodology adopted in the early 1980s by the Interstate Commerce Commission (now the Surface Transportation Board), and approved by the courts, for regulating railroad rates. *See, e.g., MidAmerican Energy Co. v. Surface Transp. Bd.*, 169 F.3d 1099 (8th Cir. 1999); *Burlington Northern R. Co. v. Surface Transp. Bd.*,

114 F.3d 206 (D.C.Cir. 1997); *Burlington Northern R. Co. v. I.C.C.*, 985 F.2d 589, 300 (D.C.Cir. 1993); *Arkansas Power & Light Co. v. I.C.C.*, 831 F.2d 569 (5th Cir. 1987); *Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444 (3rd Cir. 1987).

Forward-looking incremental cost ratemaking is partially rooted in "fair value" ratemaking, long thought by the courts to be constitutionally required under the Fifth Amendment. *See Smyth v. Ames*, 169 U.S. 466 (1898). Under fair value ratemaking, a regulated firm is entitled to recover a return on the full value of its services, which variously requires reference to a number of indicators of the market value of the firm's "used and useful" assets and the cost of reproducing those assets. David Gabel and David Rosenbaum, *Who's Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239, 246 (2000) (*"Gabel/Rosenbaum"*).

The principal criticism of fair value ratemaking was its circularity and difficulty of administration.[6] This Court eventually rejected the notion that fair value ratemaking was constitutionally required. *See Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591, 602 (1944) (*"Hope Natural Gas"*). The Court did not, however, prohibit fair value ratemaking.

This Court has declined to elevate a single theory of valuation to constitutional status. The Court has held:

> [t]he adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since

[6] According to Justice Brandeis's concurring opinion in *Southwestern Bell*, the present value of a utility could not be determined based on the "capitalizing of its net earnings, since the earnings are determined in large measure, by the rate which the company will be permitted to charge, and thus the vicious circle would be encountered." *See State of Missouri ex rel Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 292 (1923).

> *Hope National Gas, supra.* As demonstrated in *Wisconsin v. FPC*, circumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves States to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

Duquesne Light Company, 488 U.S. at 316. The Court specifically recognized that a rigid requirement of use of the historical cost methodology would "foreclose a return to some form of fair value ratemaking just as its practical problems may be diminishing." *Id.* at n. 10.

The Court in *Duquesne Light* was quite prescient in predicting the return of fair value ratemaking. As discussed above, the Surface Transportation Board, and its predecessor, the Interstate Commerce Commission, have successfully used approaches similar to TELRIC for years in determining the prices railroads may charge for use of their bottleneck facilities. As the FCC noted at the time it decided to use TELRIC, prior to the 1996 Act, a number of state public utility commissions independently employed, or had plans to employ, some form of long-run incremental cost ("LRIC") methodology in their approach to setting prices for unbundled network elements. *Local Competition Order* at ¶ 631 (FCC Pet. App. 56a-57a). The Public Utility Commission of Texas had employed LRIC-pricing methodologies for many years. *Id.* at n. 1508. Public utility commissions in Connecticut, California, Hawaii, Michigan, and Pennsylvania in 1994-1995 were requiring RBOCs to provide TSLRIC studies that are nearly identical to TELRIC for numerous services, including unbundled services.[7]

[7] CC Docket No. 96-98, Comments of AT&T Corp. at 49-50 (1996) (*"AT&T* Comments"); *DPUC Investigation into the Southern New*

Prior to the 1996 Act, the RBOCs were amongst the most ardent supporters of LRIC approaches. *See Gabel/Rosenbaum* at 257. In the late 1980s, the FCC unbundled certain services provided by RBOCs to promote efficient and innovative use of the RBOCs' networks by independent enhanced service providers ("ESPs") and to prevent discrimination on the part of the RBOCs in their offerings of certain basic service elements to competing ESPs and RBOC-owned ESPs. *In re Open Network Architecture Tariffs of Bell Operating Companies*, Order, 9 FCC Rcd. 440, ¶ 4 (1993). These unbundled basic service "building blocks" were designed to promote the ability of the RBOC's ESP competitors to compete effectively. *Id.* To develop pricing for some of these elements, the RBOCs used a forward-looking cost model, SCIS, that calculated investment costs based on replacement costs rather than historical or embedded costs. *Id.* ¶ 21; *In re 800 Data Base Access Tariffs and the 800 Service Management System Tariff and Provision of 800 Services*, Report and Order, FCC 96-392, 11 FCC Rcd. 15227, ¶ 277 (1996).

Use of a "fantasy network" thus did not originate with the FCC. In determining their costs, the RBOCs have for some time clearly relied on networks that were far from actual. The best evidence that TELRIC is not a novel or extreme methodology comes from the RBOCs themselves.

England Tel. Co.'s Cost of Providing Service, Decision at 25, 1995 WL 509180 (Conn. DPUC 1995); *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, Decision, 1995 WL 790383 (Cal. PUC 1995); *Investigation of the Communications Infrastructure of the State of Hawaii*, Order, 1995 WL 553009 (Hawaii PUC 1995); *Methodology to Determine Long Run Incremental Costs*, Opinion and Order, 156 P.U.R. 4th 1, 1994 WL 570779 (Mich. PUC 1994); *Standards and Safeguards for Competitive Services*, Decision, 1995 WL 933715 (Pa. PUC 1995).

2. *TELRIC Is Capable of Practical Implementation*

Contrary to the RBOCs' assertions, TELRIC is not inordinately complex or difficult to administer (at least in comparison to other cost-based ratemaking methodologies, none of which are particularly simple or straightforward). The FCC noted at the time of its implementation of TELRIC that a number of states had already implemented forward-looking costing methodologies to set prices for interconnection and unbundled network elements or support the use of such an approach. *Local Competition Order*, ¶ 681 (FCC Pet. App. 67a). Agencies increasingly use forward-looking cost methodologies based on economic modeling to set rates. *American Public Gas Ass'n v. FPC*, 567 F.2d 1016, 1036-1037 (D.C. Cir. 1977) (courts "have approved the use of . . . hypothetical cost projection for some producers, as a means of arriving at a reasonable individual rate"). History has borne this out as 35 state public utility commissions have applied the TELRIC methodology. *Gabel/Rosenbaum* at 245.

In fact, the historical cost methodology may be the more speculative of the two methodologies, at least in the telecommunications context. Under an historical cost approach, one must not only determine the historical costs but also if they were prudently incurred. Rate-of-return regulation based upon prudently incurred historical costs requires numerous estimates and predictive judgments.[8] Thus,

---

[8] As economists have observed:

> [I]t is uncertain as to whether the factual inquiry required for the conduct of a proper TELRIC study is any more hypothetical in nature than the judgments called for in determining whether or not capital costs, some of which were incurred decades ago, were "prudently" made or are "used and useful." Both the prudent and used and useful standards require an agency or court to ascertain the prospective demand for the products that will use the utility's facilities, the cost of alternative technologies, and the life-cycle

regardless of the methodology used, significant estimations and future cost predictions need to be made.[9] The estimations required in TELRIC are clearly not out of line with those that are a standard feature of ratemaking.

Even Justice Brandeis, who was skeptical about the speculative nature of estimating reproduction costs, noted that:

> estimating reproduction cost was useful and appropriate "as a means, either of supplying lacks in the proof of actual cost and investment, or of testing the credibility of the evidence adduced, or of showing that the cost of installation had been wasteful," and instances such as "when book values, or property accounts, furnish[] no trustworthy evidence either of cost or of real value."

Gabel/Rosenbaum at 255. In regard to pricing for interconnection and unbundled network elements, the situation Justice Brandeis described exists. As has been noted:

> The problem with this [historical cost methodology] is that the accounting systems currently used by the ILECs do not contain the data that is required for making pricing decisions regarding the provision of UNEs and the pricing of interconnection. These accounting systems were largely designed to track the financial standing of the corporation. Accounting data is typically

---

costs of the facilities. All of these factors require considerable speculation and by definition are hypothetical in nature.

Gabel/Rosenbaum at 254.

[9] *Town of Norwood v. FERC*, 53 F.3d 377, 380 (D.C. Cir. 1995). As the D.C. Circuit observed in *Norwood:*

> Long-range estimates are an integral feature of ratemaking and financial analysis in general, and we have regularly approved reliance on admittedly imperfect future cost estimates.

Norwood, 53 F.3d at 380.

> not maintained at a level of granularity that is sufficient for determining the cost of individual components of the network or tariff elements.

Id. The RBOCs' historical cost approach may thus be more hypothetical than the FCC's TELRIC methodology. TELRIC may actually be more readily administered and more reliable than the historical cost approach.

3. *The FCC's Interpretation of "Cost" Is Consistent With The Legislative History Of The Act*

The FCC, when implementing the provisions of the 1996 Act, was faced with a novel and formidable task. The FCC had to try to eradicate the effects of decades of monopoly pricing and ensure that the pricing methodology it selected would promote competition and ensure efficient competitive entry into the local exchange market. The TELRIC methodology it selected was and is the one most suited to that task. This Court in *Chevron* observed that an agency will be accorded considerable deference if its choice "represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute" and its choice will not be disturbed "unless it appears that the accommodation is not one that Congress would have sanctioned." *Chevron*, 467 U.S. at 845.

The choice the FCC made in adopting TELRIC was clearly in accord with the pro-competitive statutory policy embodied in the legislative history of the Act. The Act was designed to provide for a "pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition." P.L. 104-104, Telecommunications Act of 1996, S. Conf. Rep. 104-230 at 1 (1996). The goal of promoting competition was to "secure lower prices and higher quality services for American telecommunications consumers." P.L. 104-104, H.R. Rep.

104-204(I) at 160 (1995). As the House Commerce Committee Report noted:

> Technological advances would be more rapid and services would be more widely available and at lower prices if telecommunications markets were competitive rather than regulated monopolies.

Id. The FCC focused on implementing a cost methodology that would both be pro-competition and eliminate the vestiges of monopoly pricing.

Forward-looking pricing simulates the prices that would result in a competitive market. The FCC noted that "in dynamic competitive markets, firms take action based not on embedded costs, but on the relationship between market-determined prices and forward-looking economic costs." *Local Competition Order*, ¶ 620 (FCC Pet. App. 51a). Competition will drive prices down to forward-looking costs even if such costs are lower than a firm's historical costs. *Id.* ¶ 635.

The RBOCs argue that TELRIC hypothesizes a "fantasy world" that is divorced from the "real-world market." *Petitioners' Brief* at 9. In a "real-world" competitive world, however, companies must consider the available alternatives. If a new technology reaches the market, a company has the option of maintaining its existing plant and declining to partake of the new technology. To maintain its competitive position, however, such a company must adjust its pricing to meet the cost level that new competitors can achieve with the new technology. Thus, focusing on replacement cost is not the stuff of "fantasy"—rather, it accommodates the kind of pricing one would expect in the competitive market that Congress sought to create.

Requiring prices to be based on historical costs would distort competitive market entry decisions. As the Department of Justice noted in the *Local Competition Proceeding*, "pricing above forward-looking costs would

subject competitors to substantial risk of a price squeeze because the real cost of a network element for the incumbent LEC will be its forward-looking economic cost, while the cost to the new entrant will be the higher price charged for the element by the LEC." *Local Competition Order*, ¶ 635. ILECs would then be able to nip competition in the bud.

The RBOCs argue that use of TELRIC will distort the investment decisions of new entrants because it would "be irrational for entrants to deploy new facilities if they could purchase UNEs below any cost they could hope to achieve." *Petitioners' Brief* at 49. The RBOCs assert that this will make network elements "irresistible" and "choke off facilities-based entry." *Id.* The RBOCs fail to consider the corollary of their argument. Setting prices at historical costs levels, above long-run economic cost, will either (1) encourage inefficient facilities-based entry by rivals with costs below the ILECs' historical costs, but above the ILECs' economically meaningful forward-looking costs or (2) choke off entry altogether. Efficiency dictates that the build-buy decision be made based upon forward-looking, not historical, costs. If an RBOC can build a loop on a forward-looking basis for $15, but the RBOC's historical cost is $30,[10] the

[10] The RBOCs contend that "TELRIC prices are half the historical cost of UNEs." *Petitioners' Brief* at 31. *Amici*, by no means concede, however, that TELRIC prices are half the historical costs, or that TELRIC prices will always be lower than historical costs, particularly given the inability of RBOCs to demonstrate in a tangible manner what their historical costs are, and the manner in which particular inputs are defined by the state public utility commissions. *See supra* at 12 (discussing difficulty in quantifying RBOC historical cost) and *infra* at 23 (showing variation in cost inputs used by state commissions). In a proceeding before the North Carolina Utilities Commission, GTE, now part of Petitioner Verizon, argued that its total historical costs in North Carolina were actually "slightly lower than its total forward-looking costs." *Proceeding to Determine Permanent Pricing for Unbundled Network Elements*, NCUC Docket No. P-100 SUB 133D, Post-Hearing Brief of GTE South Incorporated at 47 (1998).

CLEC should be presented with a $15 price to buy the loop from the RBOC. If presented with an option to buy the loop from the RBOC for $30, and if the CLEC's cost to build the loop itself is $20, it will either inefficiently build the loop itself, even though the RBOC is the more efficient builder, or not enter the market at all. The folly of the RBOCs' argument is that it encourages the wasteful construction of duplicative facilities and stifles market entry.

TELRIC encourages efficient entry and precludes the wasteful deployment of facilities as demonstrated by the example above, because the new entrant will make the decision to build based on what is the most efficient and cost-effective option. As Justice Breyer noted:

> [o]ne can understand the basic logic of "unbundling" by imagining that Congress required a sole incumbent railroad providing service between City A and City B to share certain basic facilities, say, bridges, rights-of-way, or tracks, in order to avoid wasteful duplication of those hard-to-duplicate resources while facilitating competition in the *remaining* aspects of A-to-B railroad service. Indeed, one might characterize the Act's basic purpose as seeking to bring about, without inordinate waste, greater local service competition. . . .

Iowa Utilities Board, 525 U.S. at 416-417 (Breyer, J., concurring in part/dissenting in part). Congress did not want to encourage wasteful duplication of facilities by new entrants. Under TELRIC, if the economic cost to the new entrant dictates that the construction of its own facilities is more efficient and cost-effective, it will build the facilities.

The problem with the historical cost approach is that:

> [p]ermitting incumbent LECs to recover embedded costs in the prices they charge competitors for interconnection and unbundled network elements, while the incumbents experience much lower incremental costs, will result in inefficiently high prices that will either cause new

> entrants to over-build existing systems instead of maximizing the efficient use of the existing incumbent LEC's network, or discourage entry and investment in the local market altogether.

Local Competition Order, ¶ 655.

Although the RBOCs assert that TELRIC prices serve as a disincentive to CLEC investment, where UNE rates have been appropriately cost-based upon a TELRIC methodology, there has been substantial CLEC investment in facilities. Since 1997, CLECs have invested $56 billion in building their own networks. Association for Local Telecommunications Services, *The State of Local Competition 2001* at 20 (February 2001) ("*ALTS Report*"). Capital expenditures for CLECs in 2000 were valued at $24.9 billion compared to $33.6 billion for the RBOCs.[11] *Id.* at 21. CLECs reinvest a much larger portion of their revenues back into their facilities than the RBOCs, 63.7% to 20.6% respectively. *Id.* CLECs have deployed over 1,000 voice switches and 2,000 data switches. *Id.* at 24. Since 1997, CLECs have almost tripled the number of network route miles they have in service. *Id.* at 25. CLECs that either primarily rely on their own facilities, or lease unbundled network elements from the RBOCs in conjunction with their own facilities, comprise almost 70% of the CLEC market. *Id.* at 12. Thus, contrary to RBOC assertions that "many entrants rapidly changed their plans away from deploying competitive facilities," *Petitioners' Brief* at 13, there has been significant facilities-based investment under TELRIC, and this tracks what the FCC

---

[11] In January 1997, Petitioner United States Telecom Association reported that ILECs were investing more than $20 billion annually in their networks. Bruce A. Kushnick, *The Unauthorized Bio of the Baby Bells* at 202 (1999 ed.). Thus, RBOC investment under TELRIC has not decreased, but increased.

predicted would occur.[12] The FCC correctly concluded that use of TELRIC would best meet the pro-competitive goals of the Act. TELRIC ensures efficient investment decisions and competitive entry.

II. THE FCC'S TELRIC METHODOLOGY PROVIDES CONSTITUTIONALLY ADEQUATE COMPENSATION

A. The Takings Standard

This Court has found that the quasi-public/quasi-private status of a public utility creates a unique set of questions under the Takings Clause of the Fifth Amendment. *Duquesne Light*, 488 U.S. at 308. The Court has concluded that the guiding principle in analyzing takings challenges in this context is that the "Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' to be confiscatory." *Id.* This Court has declined to focus on the merits of a particular cost methodology, but rather on the overall effect and impact of use of that methodology, noting:

> [I]t is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.
>
> * * *

[12] CLECs' use of their own facilities should increase over time as CLECs build out their own networks. The purchase of unbundled network elements will serve as bridge that will provide CLECs "with the ability to gain a sufficient volume of business to justify economical deployment of their own facilities." *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, ¶¶ 52 (1999) ("*UNE Remand Order*"); *see ALTS Report* at 12.

> [T]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by the countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other respect.

Id. at 310, 313. An end result is confiscatory only if it is shown that the regulation "threatens the financial integrity of the [regulated carrier] or otherwise impedes [its] ability to attract capital." *Illinois Bell*, 988 F.2d at 1263.

B. The RBOCs' Stranded Cost Argument

The RBOCs claim that the purported shift by the FCC in pricing methodologies from historical cost to forward-looking costs "strands" half their historical costs. *Petitioners' Brief* at 28. The RBOCs argue that regulators made a compact with them:

> [b]y promising investors a fair opportunity to recover all capital prudently invested and insulating them from the risk of asset value fluctuation, regulators could insist on lower rates of return and extended depreciation schedules.

Id. at 29.[13] The threshold question is whether such a compact or contract exists.

[13] The RBOCs are espousing a "regulatory contract" theory which:

> [I]n its simplest terms, . . . is an agreement with the state that requires the utility to invest its resources in some expansion of the enterprise, such as a new power generation plant. In return, the state

This Court has long held that "in grants by the public, nothing passes by implication." *Charles River Bridge v. Proprietors of the Warren Bridge*, 36 U.S. (11 Pet.) 420, 546 (1837). As has been observed:

> [t]he Supreme Court has reiterated time and time again: When one bargains with the state, nothing passes by implication and promises are to be narrowly construed. This principle dramatically undermines the claims that utilities generally enjoy the benefits of a regulatory contract protecting them from stranded costs.

Hovenkamp at 808-09, *citing, inter alia, National R.R. Passenger Corp. v. Atchinson, Topeka, & Santa Fe Ry.*, 470 U.S. 451, 466 (1985)("a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise"); *United States v. Grand River Dam Auth.*, 363 U.S. 229, 235 (1960); *Keefe v. Clark*, 322 U.S. 393, 396-97 (1944); *Stone v. Wisconsin*, 94 U.S. 181 (1876).[14]

The RBOCs have not established, nor can they establish, that there was any such assurance from federal or state regulators that they would recover their historical costs. As the FCC noted:

> guarantees a rate of return that . . . promises to remove the risk of improvident investment.. . . If such a contract exists, deregulation and the resulting obsolescence of stranded facilities require compensation to the utilities, as the government would be reneging on its side of the regulatory bargain.

Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801, 806 (1999) ("*Hovenkamp*").

[14] Similarly, given the substantial public interest involved on the side of the government, only in the rarest cases would a plaintiff be able to succeed against the government on an estoppel theory. *Heckler v. Community Health Services of Crawford County, Inc.*, 467 U.S. 51, 59-60 (1984).

> [c]ontrary to the assertions by some incumbent LECs, regulation does not and should not guarantee full recovery of their embedded costs. Such a guarantee would exceed the assurances that we or the states have provided in the past.

Local Competition Order, ¶ 706 (FCC Pet. App. 87a).

The RBOCs have failed to demonstrate a basis that would entitle them to recovery of their stranded costs. This fact has been evidenced in recent court cases. The Court of Appeals of Arizona rejected a claim that regulators had entered a "regulatory contract" with the local ILEC. *US WEST Communications, Inc. v. Arizona Corporation Commission*, 3 P.3d 936, 941-42 (Ariz. Ct. App. 1999). The U.S. Court of Appeals for the Fifth Circuit struck down a takings challenge to TELRIC in the universal service context finding that the Supreme Court's confiscatory rulemaking decisions "do not require courts to engage in takings analysis whenever an agency opens a previously regulated market to competition." *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393, 413, n. 14 (5th Cir. 1999), *cert. dismissed*, 121 S.Ct. 423 (2000).

The New York Public Service Commission denied recovery of stranded revenues to companies operating under incentive regulation plans, such as New York Telephone and Rochester Telephone, that "gain opportunities for greater earnings" under such plans but also "bear the risk of poor earnings and stranded revenue." *Transition to Competition in the Local Exchange Market*, NY PSC Case No. 94-C-0095, Opinion No. 96-13, 1996 WL 302398, *55 (1996); *see also, Local Competition Order*, ¶ 656. NARUC, the body of state public utility commission regulators, recommended in 1996 that companies operating under price cap regulation not be allowed to recover their stranded investment costs. NARUC Staff Subcommittee on Communications, *Local Competition Work Group Summary Report* at 52-53 (1996); AT&T

Comments at 71-72, n. 105. In 1995, before the enactment of the 1996 Act, BellSouth reported a writedown of $2.7 billion because "it is doubtful that regulated rates sufficient to recover the net book value of telephone plant could be charged to and collected from customers due to expected levels of future competition." BellSouth Corporation, Securities and Exchange Commission Form 10-K, Annual Report at 34 (1995); AT&T Comments at 71-72, n. 105. Thus, even the RBOCs had no expectation of recovering stranded costs, and regulators certainly were not giving them this impression.

C. The RBOCs Were Adequately Compensated, And Will Continue to Be Adequately Compensated, for their Historical Costs

Even assuming *arguendo*, that a regulatory contract has been established, the RBOCs have failed to demonstrate that TELRIC does not adequately compensate them for their historical costs or that they have not already been adequately compensated for such costs. In fact, the FCC noted that other than advancing figures of stranded costs for which they provided no basis, no ILEC had "provided persuasive evidence that prices based on a forward-looking economic cost methodology would have a significant impact on its 'financial integrity,'" which is the relevant standard under *Illinois Bell*. *Local Competition Order* at ¶ 738 (FCC Pet. App. 95a). The FCC, in fact, left the door open for ILECs to make such a showing, and if they were able to do so, they could petition to seek relief from the methodology. *Id.* ¶ 739 (FCC Pet. App. 95a). No ILEC has even attempted to make such a showing of significant stranded costs.[15]

---

[15] Jim Chen, *Standing in the Shadows of Giants: The Role of Intergenerational Equity in Telecommunications Reform*, 71 U. Colo. L. Rev. 921, 935 (2000).

As noted above, it would be very difficult for the RBOCs to quantify their historical costs, much less do a comparative analysis. The FCC correctly concluded that based on the record before it that there was no support for the claim that significant residual costs would result from the use of a forward-looking methodology. *Local Competition Order*, ¶ 707 (FCC Pet. App. 88a). As a commenter in the *Local Competition* proceeding noted, "nominal losses in economic value attributed to stranded investment should be weighed against the appreciation in value that incumbent LECs have experienced in share prices and market-to-book ratios." *Local Competition Order*, ¶ 659. RBOCs have claimed that they have had to carry reserve deficiencies as a result of lengthy depreciation schedules dictated by regulatory bodies, but the market data belies this claim. The limited available market data "clearly shows that the book value of the ILEC assets is significantly less than the market value of the assets." *Gabel/Rosenbaum* at 266. As these economists conclude, "the fact that ILEC exchange assets are commanding prices on the open market which are of a magnitude greater than their book value vitiates the ILECs' contention that implementation of TELRIC will result in stranded costs." *Id.*

The RBOCs also fail to show that TELRIC will not adequately compensate them for any stranded cost that may occur. As the FCC noted, TELRIC provides an adequate return to the RBOCs because "properly designed depreciation schedules should account for expected declines in the value of capital goods." *Local Competition Order*, ¶ 686 (FCC Pet. App. 71a-72a).

The RBOCs mistakenly argue that the FCC has ensured that TELRIC will yield massive price reductions by maintaining low-risk cost of capital and extended depreciation rates transplanted from the monopoly regime. *Petitioners' Brief* at 10. In fact, the FCC left the determination of cost of capital and depreciation rates to the states and clearly encouraged the use of cost-of-capital and depreciation rates

that would adequately cover the RBOCs' cost of capital and accurately reflect the economic lives of their facilities. *Local Competition Order*, ¶ 702 (FCC Pet. App. 83a). The implementation of TELRIC has borne this out. For instance, the FCC had opined that its proposed cost of capital figures of 11.25% may have been too high given the current marketplace cost of equity and debt, but it opted for a forward-looking figure that would generate higher costs than warranted by the actual state of competition. *Id.* The Massachusetts Department of Telecommunications and Energy went beyond the high FCC figure and utilized a cost of capital of 12.16 percent that was higher than the cost of capital it has used in setting Petitioner Verizon's retail local rates. *Application of Verizon New England Inc., et al., for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, CC Docket No. 01-9, Memorandum Opinion and Order, FCC 01-130, 2001 WL 388287, ¶ 38 (Apr. 16, 2001).

The Indiana Utility Regulatory Commission ("IURC") likewise allowed for the economic lives that were substantially shorter than those prescribed by the FCC, and shorter than those suggested by the historical life indications of Ameritech's existing facilities,[16] in order to reflect a possible need to upgrade equipment more quickly to compete in an evolving market. *IURC UNE* Order at 9-10. Thus, far from being restricted to use of depreciation rates and cost of capital from the monopoly regime, *Petitioners' Brief* at 10, the RBOCs have been pushing for, and often receiving, forward-looking depreciation rates and costs of capital that go beyond the competitive risks they face.[17]

---

[16] Ameritech is a subsidiary of Petitioner, SBC Communications, Inc.

[17] In fact, in a recent filing with the Massachusetts Department of Telecommunications and Energy, Verizon, contrary to the argument it makes here, cited the *Local Competition Order* for the proposition that TELRIC requires a forward-looking cost of capital. *Compare* MA DTE Docket No. 01-20, Direct Testimony of Dr. William Taylor on Behalf of Verizon New England d/b/a Verizon Massachusetts at 11 (May 4, 2001) *with Petitioners' Brief at* 10.

The application of TELRIC has demonstrated that it protects the financial integrity of the RBOCs. Two economists who studied the profitability of RBOCs since the enactment of the 1996 Act found:

> Given the rates of return on regulated investment, and the rates of return on embedded investment, it seems clear that the majority of telephone companies in the survey are earning returns that are more than sufficient to assure confidence in the financial integrity of their enterprises, maintain their credit worthiness and to enable them to attract additional capital. Based on this data it would seem that the ILECs and their supporters' contention, that use of the TELRIC methodology, on its face, results in a taking, is not grounded in the reality depicted by their earnings reports.

Gabel/Rosenbaum at 265. The RBOCs have failed to show that, even if they are entitled to recovery of any stranded costs, TELRIC fails to provide them with constitutionally adequate compensation. Clearly the financial integrity of their enterprises has *not* been imperiled, and is in no danger of being imperiled.

In fact, it is premature to consider if there will be a shortfall. As noted in the *Local Competition* proceeding, "the size of any shortfall between historical costs and TSLRIC's forward-looking costs will not be determined for many years after interLATA entry." *Local Competition Order*, ¶ 655. Petitioners concede that interstate access and long distance charges are two sources of revenue that may provide recovery for stranded costs. *Petitioners' Brief* at 36, n. 15. For instance, access charges for years have been set well in excess of the Petitioners' economic costs of providing access

service to provide subsidies for universal service. Alfred Kahn & William Shew, *Current Issues in Telecommunications Regulation: Pricing*, 4 Yale J. Reg. 191, 193-95, 202, n.28 (1987). Likewise, the RBOCs' entry into the interLATA market pursuant to the 1996 Act will provide substantial revenue that should more than compensate for any nominal stranded cost there may be. It should not be forgotten that the RBOCs were among the supporters of the 1996 Act, and it is reasonable to believe that it was their recognition of the lucrative benefits of interLATA entry that fueled this support. *See*, P.L. 104-104, S. Rep. 104-23 at 26-29 (1995). Thus, regulators could use revenues from one of these areas to offset any deficiency that arises from UNE rates, if such a deficiency is ever demonstrated by the RBOCs.[18]

III. INVALIDATING TELRIC AT THIS STAGE WOULD UNDO THE COMPETITIVE ADVANCES MADE SINCE 1996

As has been demonstrated, the FCC clearly made not only a reasonable choice, but the appropriate choice. The choice was made after much deliberation and evaluation of the alternatives and was substantially supported by the record elicited in the proceeding. The choice of TELRIC resulted in a rate order, the total effect of which is reasonable and does not imperil the financial integrity of the RBOCs. As this

[18] *See, Qwest Corporation v. U.S.*, 48 Fed.Cl. 672, 696 (2001). The Court of Federal Claims noted that Plaintiff Qwest's physical takings claim must be considered in the "context of the comprehensive legal framework established by the Telecom Act." *Id.* The court noted that the Telecom Act "created a matrix of interlocking opportunities for ILECs" where "they could enter some new markets, but the *quid pro quo* was that they open up their own local exchange markets to competition." *Id.; see also, National Railroad Passenger Corp. v. Boston and Maine Corp.*, 503 U.S. 407, 418 (1992) (upholding broad construction by Interstate Commerce Commission of its condemnation authority that implemented and interpreted the statute in a manner that comports with its words and structure).

Court has noted, under these circumstances, judicial inquiry must end, and deference be given to the choice of the expert agency.

Courts are reluctant to encroach on the province of expert agencies particularly when "the economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result." *Duquesne Light*, 488 U.S. at 314. As this Court has astutely observed, "the Constitution is not designed to arbitrate these economic niceties." *Id.* If the Court were to invalidate TELRIC at this time, it would undo the competitive inroads that have been made in the telecommunications industry and imperil the already precarious state of local competition. It would also "strand" billions of dollars that have been invested in the CLECs and their facilities. The invalidation of TELRIC would undermine the very pro-competitive goals that provide the foundation of the 1996 Act.

The replacement of TELRIC with an historical cost approach will not eliminate the asserted problem of stranded investment, as now it will be the CLECs whose investment will be stranded. As described above, the CLECs have invested over $56 billion in building their networks since 1997. CLECs properly based their decisions to enter markets and make investments based on the relationship between market-driven prices and forward-looking economic costs. A shift in the methodologies to historical costs would trap the CLECs in the price squeeze described above. For example, Petitioners argue that in New York the average historical cost for a copper loop is $33.20 per month while the TELRIC price is $14.52 per month.[19] *Petitioners' Brief* at 14. The

[19] Once again, it should be noted that *Amici* do not concede the validity of Petitioners' unsubstantiated historical cost figures. These figures are simply used by *Amici* to show that, taking Petitioners' figures at face value, basing UNE rates on such figures would either lead to wasteful deployment or exit of some competitors.

forward-looking cost for the CLEC to construct its own loop would be higher than the forward-looking cost for the RBOC because the CLEC does not have the same economies of scale and large customer base that the RBOC has. *See, Local Competition Order*, ¶¶ 655, 679 (FCC Pet. App. 66a); *UNE Remand Order*, ¶¶ 181-183. Thus, in most cases, the CLEC's cost to deploy that loop itself would be expected to be higher than $14.52 per month.[20]

If the CLEC chooses to build the loop itself, this is wasteful and an inefficient use of resources as it is more efficient for the RBOC to build the loop. As the FCC has noted, requiring CLECs to self-provision facilities such as loops would "materially raise entry costs, delay broad-based entry, and limit the scope and quality of a competitor's offerings," and is "not an adequate alternative for loops that a carrier can obtain from an incumbent LEC." *UNE Remand Order*, ¶ 181; *see id.* at ¶ 182. The historical cost approach would thus lead to the inefficient overbuilding of facilities that will delay competitive entry. Petitioners argue that the "expeditious introduction of competition" is one of the important objectives of the Act, but their approach would put the brakes on such competitive entry. *Petitioners' Brief* at 46; *see also*, at 48 (Congress "envisioned a system in which entrants achieved efficiencies and introduced innovations that gradually created the genuine benefits of a competitive market . . . .")

Some CLECs who have built some facilities (those as to which the ILEC does not have a particular cost advantage) while leasing others (as to which the ILEC has a cost advantage because of economies of scale) from ILECs at TELRIC prices may find that under the historical cost approach it is cost-prohibitive to compete. The investments made by these CLECs in their own facilities will be stranded

[20] The FCC has estimated that it costs $885 per line to construct a local exchange network. *Petitioners' Brief* at 11, n. 6.

by the change in methodology. They made a decision to enter the market based on forward-looking prices for network elements and invested in other facilities based upon the expectation of being able to lease bottleneck facilities from the ILEC at forward-looking prices. A doubling of the price for a leased facility, as Petitioners contend, may make continued use of that facility so costly that they have to exit the market. This would frustrate the goal of promoting competition.[21]

Invalidation of TELRIC may also imperil much of the competitive entry that has been made in the past five years. While CLECs have made substantial investments to enter markets, ILECs still dominate the local exchange market. The ILECs control 92% of all local access lines. *ALTS Report* at 9 (Feb. 2001).

Use of an historical cost approach will effectively preclude CLEC utilization of ILEC network elements since it would be cost-prohibitive to do so. Thus, CLECs, if they desire to remain in the market, will be forced to overbuild ILEC facilities at a time when available capital is scarce. Under this scenario, available capital will be wasted on an inefficient duplication of ILEC facilities when it would be much more efficient and reasonable for the CLECs to lease network elements from the ILEC. The capital wasted could be more prudently invested in needed facilities to extend the reach of telecommunications service, rather than to create duplicative facilities.

The question ultimately becomes at what price do we want to ensure the RBOCs' recovery of their purportedly "stranded" costs. The recovery of these costs creates costs of

[21] The implications of the historical cost approach are not limited to use of unbundled network elements. TELRIC is also utilized to price interconnection and collocation services that are vital for connecting the networks of two separate carriers. Basing interconnection and collocation prices upon historical costs will further impede competition.

their own. As Professor Chen notes, "stranded cost recovery, whether by legislative order or by a judicial finding of confiscatory ratemaking, shifts costs from past utility investors squarely onto the shoulders of current and future customers." *Chen* at 936. In 1996, Congress knew the actions it would take might alter the financial bottom-line of the RBOCs, but it felt that the advent of competition in the local market was worth this cost. Additionally, it gave the RBOCs incentive to allow for such competition by providing for their entry into the long distance market once certain requirements are met. By implementing TELRIC, the FCC merely made manifest the choice Congress had already made, *i.e.*, to adopt a methodology that will promote the rapid and efficient development of competition. The RBOCs, now well on their way to achieving entry into the long distance market, ask this Court to turn back local competition and retreat to the monopoly days where their returns were protected, but at the price of competition. This Court should reject this overture and defer to the reasonable and appropriate choice made by the FCC.

CONCLUSION

Wherefore, *Amici* respectfully request that this Court deny the appeal of Petitioners Verizon Communications, Inc., *et al.*, and uphold the Order of the Federal Communications Commission pertaining to its TELRIC methodology.

Respectfully submitted,

MARY C. ALBERT
Vice President, Regulatory and Interconnection
MORTON J. POSNER
Regulatory Counsel
ALLEGIANCE TELECOM, INC.
1150 Connecticut Avenue, N.W.
Suite 205
Washington, D.C. 20036
(202) 464-6106
Counsel for Allegiance Telecom, Inc.

STEPHEN ZAMANSKY
General Counsel
DSLNET COMMUNICATIONS, LLC
545 Long Wharf Drive, 5th Floor
New Haven, Connecticut 06511
(203) 772-1000
Counsel for DSLnet Communications, LLC

RUSSELL I. ZUCKERMAN
Senior Vice President & General Counsel
RICHARD E. HEATTER
Vice President, Legal Affairs
FRANCIS D. R. COLEMAN
Vice President, Regulatory Affairs
MPOWER COMMUNICATIONS CORP.
175 Sully's Trail—Suite 300
Pittsford, New York 14534
(716) 218-6568
Counsel for Mpower Communications Corp.

ANDREW D. LIPMAN
ERIC J. BRANFMAN
HARISHA J. BASTIAMPILLAI *
SWIDLER BERLIN SHEREFF FRIEDMAN, LLP
3000 K Street, N.W.
Suite 300
Washington, D.C. 20007
(202) 424-7500
Counsel for Amici Curiae
Counsel of Record *

ROBERT W. BAKER
Vice President and General Counsel
EL PASO NETWORKS, LLC
1001 Louisiana Street
25th Floor
Houston, Texas 77002
(713) 420-7021
Counsel for El Paso Networks, LLC

SUMNER N. SMITH
Senior Corporate Counsel
US LEC CORP.
6801 Morrison Boulevard
Charlotte, N.C. 28211
(704) 319-1119
Counsel for US LEC Corp.

June 8, 2001